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A fight between democrats and populists: leader

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Politics this week

May 18th 2006
From The Economist print edition

EPA

The sectarian carnage in **Iraq** continued, especially in Baghdad. The prime minister-designate, Nouri al-Maliki, promised to unveil a national unity government, with top jobs shared out among the country's three main groups, before the constitutional deadline of May 22nd.

Clashes between Islamist gunmen and the warlords' Alliance for the Restoration of Peace and Counter-Terrorism continued in **Somalia**'s capital, Mogadishu, despite a ceasefire that was signed on May 14th.

Israel's Supreme Court narrowly rejected petitions from two human-rights groups to overturn a law that stops Arab residents of the West Bank and Gaza who marry Israelis from getting Israeli citizenship, residency or entry permits. See article

Mahmoud Abbas, the **Palestinian president**, sent thousands of police to the Gaza Strip after the new Hamas government challenged his authority by deploying its own armed militias.

The United States resumed full diplomatic relations with **Libya**, once one of its most virulent critics, as a reward for helping America in its war against terrorism and for abandoning plans to acquire weapons of mass destruction. See article

The UN Security Council endorsed a peace accord in Sudan's troubled western province, **Darfur**, and called for a UN peacekeeping force to replace the struggling African Union force as fast as possible.

Nigeria's president, Olusegun Obasanjo, accepted the verdict of the Senate after it defeated a bill that would have let him run for a third term of office. See article

Crime spree

Some 150 people were killed, a quarter of them policemen, after a criminal gang, based in the prison system, launched attacks on police stations, buses and bank branches in and around **São Paulo**, Brazil's largest city. The gang's leaders opposed their imminent transfer to a maximum-security jail, and wanted televisions to watch the soccer World Cup. See article

Ecuador's government joined the wave of oil nationalism sweeping Latin America, ending a contract with Occidental, an American oil company that is the largest foreign investor in the country. The government said it would not pay any compensation. See article

Bolivia's leftist government outlined plans to redistribute idle agricultural land. Officials said this would not involve expropriation, but landowners expressed concern. The government also said that it would take control of private pension funds' shares in the state-owned oil company and review the contracts under which private firms run the country's airports. See article

Reuters

The United States' government said that it would ban arms sales to **Venezuela**. It said that Hugo Chávez's government was not co-operating in fighting terrorism. Mr Chávez brushed off the announcement, saying: “it's the empire”.

The Dominican Liberation Party of Leonel Fernández, the reforming president of the **Dominican Republic**, seemed to have won a majority in a congressional election. Officials said that turnout was low. See article

Huddled masses

President George Bush announced a plan to send up to 6,000 members of the National

Guard to the **Mexican border** for at least a year. At the same time he repeated his desire for a guest-worker programme to allow illegal immigrants to work legally and, eventually, become citizens. See article

Anxious to energise the Republican base before November's mid-term elections, Mr Bush signed into law $70 billion in **tax cuts**. They included a two-year extension of the reduced 15% tax rate for capital gains and dividends, which Democrats had condemned as a sop to the rich.

The Republican governor of Kentucky, **Ernie Fletcher**, was indicted on charges of handing out government jobs as political favours. He is the third governor to be indicted in the state's history. See article

All in good time

The European Commission recommended that a decision on whether **Bulgaria and Romania** should join the European Union on January 1st 2007 should be postponed until the autumn. It also recommended that Slovenia, but not Lithuania, should be allowed to join the euro. See article

The new **Italian prime minister**, Romano Prodi, announced his government. The finance minister will be Tommaso Padoa-Schioppa, a former central banker; the foreign minister will be Massimo D'Alema, who was prime minister in the late 1990s. See article

A prominent Somali-turned-Dutch critic of Islam, **Ayaan Hirsi Ali**, said she was leaving the Netherlands for America after she was found to have falsified her asylum application. She was also stripped of her Dutch citizenship. Ms Hirsi Ali wrote the script for a controversial film attacking Islam made by Theo van Gogh, who was murdered two years ago by a radical Islamist. She has since been living under police protection. See article

A gunman shot dead one judge and wounded four others in a senior court in **Turkey**. The motives for the attack were unclear, but one of the wounded judges had ruled last year against teachers wearing the Muslim headscarf. Some reports said the gunman shouted “I am the soldier of God” as he fired.

Typhoon troubles

AP

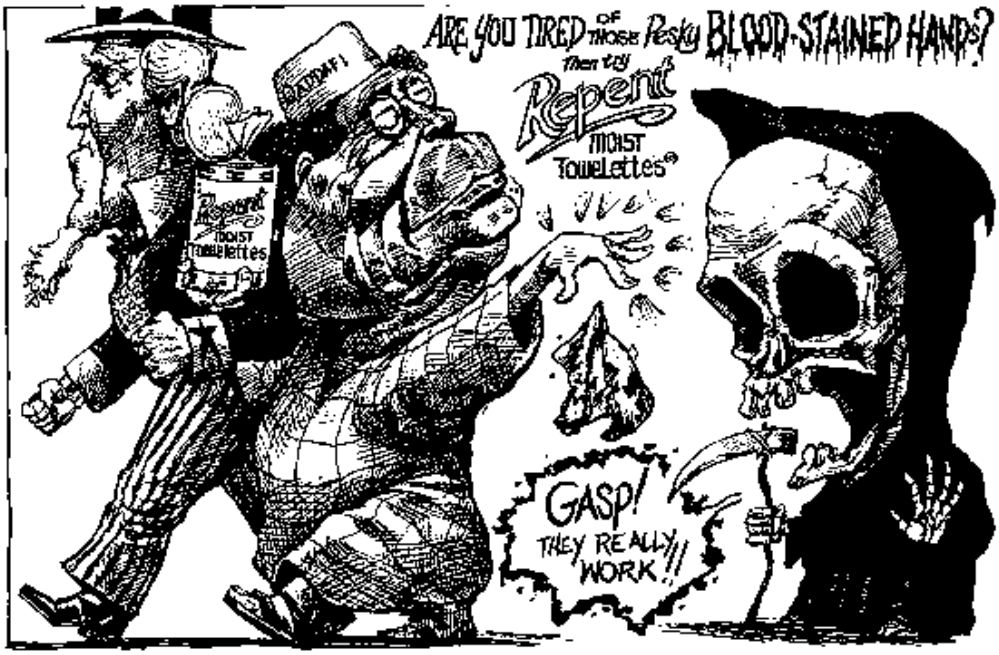
Almost a million people were evacuated as Typhoon Chanchu hit **southern China.** At least eight people were killed and dozens of Vietnamese fishermen were reported missing at sea.

About 60 people were reported killed in a clash between Taliban fighters and the police in the Helmand province of southern **Afghanistan** where thousands of British troops are currently deployed.

Five people died of bird flu in **Indonesia**, bringing the death toll there to 30. The government said there was no evidence of transmission between humans.

Vietnam's prime minister, Phan Van Khai, announced that he is to step down after serving two five-year terms. He nominated Nguyen Tan Dung, his 56-year-old deputy, to succeed him.

The chairman of Hyundai Motor was indicted in **South Korea** for his alleged role in a bribery and embezzlement scandal. Chung Mong-koo is accused of creating funds that were used to bribe politicians and officials.



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Business this week

May 18th 2006
From The Economist print edition

Financial markets had a nervous week. Higher-than-expected inflation numbers in America, released on May 17th, led to expectations that the Federal Reserve would continue raising interest rates. Soaring petrol prices contributed to consumer-price inflation of 0.6% in April. Equities and government bonds fell in turn. The **dollar** wobbled amid expectations that it may need to fall further because of global economic imbalances. Gold and oil prices tumbled. Metals prices, hit earlier in the week, later recovered. See article

Vivendi rejected an informal bid approach of more than *euro*40 billion ($51.4 billion) from Sebastian Holdings, a private-equity group. Vivendi denied that an actual approach was made, but it has voiced concerns that a takeover of the company would possibly mean breaking it up.

Undermining

Xstrata bid C$16.1 billion ($14.5 billion) for **Falconbridge**, a Canadian mining company, in an effort to thwart a merger between two rivals. The Swiss firm offered C$52.50 a share in cash for the 80% of Falconbridge it does not already own. The bid tops an earlier offer from Inco, another Canadian mining firm. The deal would create one of the world's biggest mining companies. Analysts predicted that Inco would raise its offer, potentially leading to a takeover battle.

Amid a flurry of speculation about consolidation among **financial exchanges**, shareholders at Borsa Italiana met in Milan to consider the prospect of going public, a move its chief executive favours. Shareholders at the Spanish markets operator, BME, will consider a similar move on June 5th. Meanwhile, the London Metal Exchange is planning a review that could lead to a change in its ownership structure and, potentially, a future listing. See article

Standard & Poor's, a rating agency, downgraded **NASDAQ**, a big American financial exchange, to junk-bond status. The agency cited NASDAQ's debt, part of which is due to its 24% stake in the London Stock Exchange.

Some of Europe's biggest **energy groups** were raided by EU competition regulators. Brussels is intensifying an antitrust investigation into alleged competition abuses in the electricity and gas industries. Co-ordinated raids were held at more than 20 sites in six countries. The raids targeted offices of e.ON, RWE, Gaz de France, Eni and OMV.

Results in store

Wal-Mart said its profit rose by 6.3% in the first quarter, driven by the biggest sales gain in two years. The result exceeded analysts' expectations, with same-store sales rising by 3.8%. But the big retailer's chief executive, Lee Scott, gave warning that rising petrol prices could affect this quarter's sales. Wal-Mart's international sales rose by 23%, but profit and same sales fell at Asda, its supermarket chain.

Target, another big retailer, said first-quarter earnings rose by 12%, to $554m. Despite this, it reported the first decline in profit in the past two years. Home Depot, a big home-improvement retailer, said first-quarter profit rose by 19% from a year earlier. The result failed to meet analysts' expectations, and Home Depot's shares fell. See article

The Securities and Exchange Commission said it will not exempt small companies from investor-protection rules in the **Sarbanes-Oxley** Act. It will, however, postpone implementation for them. The decision was a disappointment for business groups.

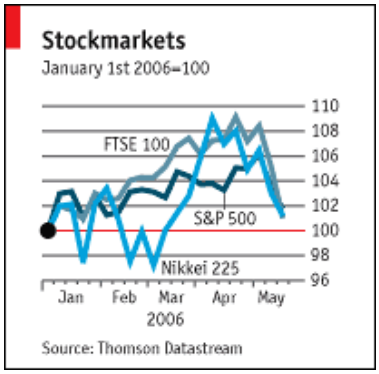
Eurotunnel, the Anglo-French group that operates the cross-channel rail tunnel, held talks with creditors and banks about restructuring its £6.2 billion ($11.7 billion) debt to avoid bankruptcy. In April Eurotunnel said it could not guarantee its survival beyond the end of 2006.

Hewlett-Packard said sales grew by 5%, to $22.6 billion, in its second quarter from a year earlier, meeting most analysts' projections. The printer and computer maker said operating profit was $1.7 billion, on a general accounting basis. The firm plans to consolidate 85 data centres around the world into six large facilities in America, which it projects will save about $1 billion in costs per year in future.

Economic growth in **Africa** should reach 5.8% this year, and 5.5% in 2007, according to a report from the OECD. Oil-exporting nations are leading growth in the region. Strong global demand for other raw materials is another factor in the economic growth. But other nations in the region continue to struggle.

Global **share prices** tumbled. Leading share indices have sunk in America, Britain and Japan. India's stock index had its biggest drop ever.

China removed a year-long ban on initial public offerings. A long list of companies is waiting to raise money.



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Latin America

The battle for Latin America's soul

May 18th 2006
From The Economist print edition

A fight between democrats and populists

"LATIN AMERICA doesn't matter...people don't give one damn about Latin America." So said Richard Nixon, offering career advice to a young Donald Rumsfeld. With the bloody exception of the Central American wars of the 1980s, Nixon was right—until now. Suddenly Latin America has grabbed the world's attention. There are several reasons for this. But they come down to the notion that, after two decades in which country after country in the region seemed to embrace liberal democracy and market capitalism, something fundamental is changing.

A spectre has arisen, one of anti-American leftist nationalism. Ecuador this week became the latest Latin American country to kick out a foreign energy company—in its case, Occidental. But there are plenty of other signs that all is not well. The crime mobs created by foreign demand for cocaine continue to run amok. More than 100 people have died in a fight between one of these mafias and the state in São Paulo, the region's most modern metropolis (see article). The tide of migrants fleeing lack of opportunity in Latin America has become a bitter issue north of the border, especially with the Republican right. That has prompted George Bush to offer up to 6,000 National Guard troops to patrol the border (see article). His administration has also announced a (largely symbolic) ban on arms sales to Venezuela, which is run by the noisiest of the anti-*Yanqui* nationalists, Hugo Chávez, because, it is claimed, he is not co-operating in fighting terrorism.

Yet to portray what is happening in the Americas as a battle between the United States and its Latin neighbours is mistaken. Latin America does matter—but not quite, or not only, for the reasons commonly believed. The battle being waged is one within Latin America over its future. It is between liberal democrats—of left and right—and authoritarian populists. Latin America's efforts to make democracy work, and to use it to make searingly unequal societies fairer and more prosperous, have implications across the developing world.

Those efforts suffered a severe blow in 1998-2002, when the region suffered financial turmoil and economic stagnation. Rightly or wrongly, voters blamed the slowdown on the free-market reforms known as the Washington consensus. As happens in democracies, they started to vote for the opposition—which tended to be on the left. Yet in Latin America, as this newspaper has often noted, the differences among the left-wing governments are more important than the similarities.

Broadly speaking, one camp is made up of moderate social democrats, of the sort in office in Chile, Uruguay and Brazil. The other camp is the radical populists, led by Mr Chávez, who appears to have gained a disciple in Evo Morales, Bolivia's new president. The populists shout louder, and claim that they are helping the poor through state control of oil and gas. Neither Mr Chávez nor Mr Morales is from the "white" elites who, in caricature at least, have long ruled in the region. Both direct volleys of abuse at Mr Bush. For all these reasons, the populists have captured the sympathy of ignorant paternalists abroad, such as London's mayor, Ken Livingstone, who this week welcomed Mr Chávez as "the best news out of Latin America in many years".

The facts speak otherwise. Yes, after seven years in power and a massive oil windfall, Mr Chávez has finally created some health and education programmes for the urban poor. At last, poverty is falling (though it is still

around 40%) in Venezuela—but it would be extraordinary if it were not, given the oil price. Yes, Mr Chávez has twice been elected and remains popular. But he is running down his country's wealth. Having dismantled all checks, balances and independent institutions, his regime rests on his personal control of the state oil company, the armed forces and armed militias.

Look around the rest of Latin America, and there is plenty of better news. In the current spate of elections, the populists are not carrying all before them. That is partly because the region's economies are now doing well again (see article), but it is also because some democrats seem to have learnt a salutary lesson. This is that governments neglect education, health and anti-poverty programmes at their peril.

Governments in Chile, Colombia, Mexico and Brazil are starting to achieve sustained reductions in poverty—and even in inequality—partly by more effective social policies. The difference will become even clearer when commodity prices fall and the economic cycle turns. Chile will then be able to maintain its social programmes by spending what it has saved from its copper windfall. By contrast, Venezuela's future may resemble not Cuba, as some of Mr Chávez's opponents fear, but Nigeria—a failed petro-state.

In place of drugs and migrants

It has become commonplace to berate Mr Bush for “losing” Latin America. But that is to overstate the influence of the United States in South America and Mexico (though not in the smaller countries of the Caribbean basin). Relations between the two halves of the Americas are not as good as a decade ago, yet the bigger change is the disarray within Latin America itself, largely provoked by Mr Chávez and his allies (who include Fidel Castro, Cuba's communist gerontocrat).

That said, the Bush administration could do more to help. Mr Bush's gesture towards tightening border security is a blow to America's friends in Mexico. If it is the price for approving the Senate's version of immigration reform, which includes routes to citizenship for illegals and expands legal migration, so be it. But it would help Latin America greatly if the United States coupled its trade deals with a more generous partnership for development, including targeted help with infrastructure—and if it accepted that its “war on drugs” has failed.

Meanwhile, democrats everywhere—including in Europe and in Latin America itself—need to make it clear on which side of the battle they stand. They should not welcome Mr Chávez in their midst unless the presidential election in Venezuela in December is demonstrably free and fair. Restoring democracy in Latin America cost too much blood for the achievement to be lightly thrown away.

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Bad memories in China

The cultural what?

May 18th 2006
From The Economist print edition

China needs to come to terms with its past

TO OUTSIDERS, there is something faintly comical about China's Cultural Revolution, which started 40 years ago this week and only ended with the fall of the Gang of Four ten years later. The “struggle sessions”, the self-criticisms, the absurdly elongated dunce's caps, the massed hands waving Chairman Mao's little red book, the rampaging Red Guards; with hindsight, all seem to belong more to farce than tragedy.

To anyone forced to live through it, however, there was nothing remotely amusing about China's “lost decade”. Hundreds of thousands of people were murdered; hundreds of millions had their lives shattered. Neighbours informed on one another, children betrayed their parents and the machinery of government was destroyed. An entire generation learned to trust no one, with consequences that mark China today (see article).

The Cultural Revolution was one of the 20th century's greatest barbarisms. Yet that is little understood, for the same reason that this editorial will probably not be read in China. Publications containing articles on such subjects are routinely impounded, because China's Communist Party dare not allow examination—let alone criticism—of its mistakes. What little is known about the Cultural Revolution has come mostly from individual memoirs published abroad that are dangerous to own in China. Not only has there never been a full accounting of the period inside China, there have been very few books, seminars or newspaper articles about it. In 1981, the era was officially condemned and there have been some approved histories. But the extent of the tragedy has never been admitted. This week's anniversary passed in profound silence among those so badly scarred by Mao's insane vision.

The Communist Party's failure to confront its past is one of its greatest weaknesses. The Cultural Revolution is not the only appalling policy to have been brushed under the carpet. Before it there was the Great Leap Forward, an ideological experiment that created the greatest man-made famine in history. After it came the Tiananmen Square massacre. None of these disasters can yet be debated openly in China. Even discussion of events that happened more than a century ago can land people in trouble, as the editor of a magazine that expressed heretical views about the Boxer Rebellion of 1899 found to his cost earlier this year. Yet an understanding of the enormities of the past is essential to a saner future. And such understanding is impossible without knowing the facts.

Nastiness in the neighbourhood

The Communist Party's blindness to history has consequences beyond China, too. One of the greatest irritants in relations between China and Japan is Chinese indignation over Japan's use of school textbooks which (in a tiny number of cases) minimise Japan's past atrocities in China. But the lame propaganda that passes for history in all of China's schoolbooks is shameful too, and helps keep this dispute simmering on. More profoundly, China's neighbours find it hard to trust a government that cannot be more honest about itself.

China has done an impressive job in restructuring its economy and opening it to the world. In the process the party

has helped rescue millions from Mao's mistakes. Yet the human urge for accountability is not to be underestimated. One day there will be a reckoning. China's Communists may end up wishing they had had the courage to lead it themselves.

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Currencies

On the slide

May 18th 2006
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The dollar's decline seems finally to be under way. It still won't balance America's books

A GIGANTIC current-account deficit ought to be bad news for a currency. For the dollar, reality seems at last to be coming into line with the textbooks. In the past month or so the greenback has lost 6% against the euro, 7% against the yen and 3% on a broad trade-weighted basis. This week it dipped below eight yuan for the first time since China abandoned its fixed rate of 8.28 to the dollar last July. Even before the markets' recent upset, caused largely by inflation worries (see article), there was reason to believe that the dollar was on the prolonged slide that economic logic suggests is overdue.

Before anybody starts talking about a turning point it is worth considering two caveats. First, the dollar has defied gravity less dramatically than many people think—especially once you cast your gaze beyond the euro, the yen and the yuan. The dollar's broad trade-weighted index has fallen by 18% since February 2002. Last year, notes Jim O'Neill, of Goldman Sachs, the greenback lost against the Canadian dollar (which has a weight almost as big as the euro's) and some important emerging-market currencies such as the South Korean won (which counts for about the same as the pound sterling).

The second caveat is that once you look at the euro and the yen, the dollar has been here before, and not that long ago. At the start of 2005, the greenback was weaker against both the euro and the yen than it is now, but gained against both currencies in the course of the year. Asian central banks, which have helped sustain both the current-account deficit and the dollar by buying Treasury bonds in startlingly large quantities, have little interest in a weaker greenback. Oil-exporting countries are also thought to have been putting at least some of their extra revenues into dollar-denominated assets, including treasuries. Neither source of current-account funding looks likely to dry up just yet. And even this week, some investors have shown that they see the dollar as a safe haven.

Against these caveats there are a number of reasons to argue that something fundamental may just have shifted against the dollar. The first is the removal of a temporary prop. Last year American companies were allowed a lower tax rate on profits repatriated from abroad. Now, that support for the external deficit and the dollar has been taken away.

A second change has to do with international differences in interest rates. Until recently, the dollar was helped by the Federal Reserve's policy of raising interest rates (a quarter of a percentage point at 16 consecutive meetings after June 2004) at a time when the Europeans held steady. Now the tables are turned: markets are worried that the Fed will stop at 5%, but the European Central Bank is raising interest rates and will probably soon be joined by the Bank of Japan.

This is linked to a third point: there has been a change in beliefs about how economies are faring. Whereas the rattling pace of America's economy is expected to slacken in the second half of the year, the slower-growing euro area and Japan are thought to be picking up—even if in Europe this is still more evident in confidence surveys than in hard figures. Fourth and most pressing, there are deeper concerns about the American economy. Wall Street is much more worried about inflation than it was a few months ago—and markets are yet to be convinced that the Fed's newish chairman, Ben Bernanke, will tackle inflation with sufficient vigour.

It would be nice to think that the dollar's decline heralded an orderly adjustment of global imbalances (the greenback's latest tumble may have been started by a stern communiqué from the G7 last month about the world economy). But do not get your hopes up. Although a fall in the dollar should help to reduce America's current-account deficit, by making exports cheaper and imports dearer, it will have to go a lot further to make much of a dent. Indeed, the current-account deficit has carried on climbing these past few years, even though the greenback has been weakening for most of the time. One way or another, America is still going to have to save more and the rest of the world save less.

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America's banking boom

Time to lose weight?

May 18th 2006
From The Economist print edition

Bankers may have to concentrate on the bank they already have—not the one they want to buy

THIS decade has been the best in living memory for America's commercial banks—so far. As our survey this week points out, banks have been growing fast around the world, from Tokyo to Moscow. But nowhere does the industry seem more triumphant than in the United States. Last year American banks declared a fifth straight year of record earnings. Their return on equity has been at a 60-year high. No bank has failed for almost two years, an all-time record.

Normally, this is exactly the time in the boom-bust cycle of banking to start worrying about credit quality and over-lending. It is certainly true that external conditions have been unusually benign. Inflation and interest rates have been low, economic growth strong, and financial markets buoyant. This week's wobbles may presage more volatility ahead: banks may rue the money they have lent to hedge funds, especially when it is secured against illiquid derivatives. And when America's property bubble is finally pricked, there will surely be nasty surprises for its banks there too.

Yet there are some reasons for cautious optimism when it comes to both regulators and bankers. Broadly speaking, the former have got it right. Regulators have opened up the industry, getting rid of interstate banking restrictions in 1994 and breaking down the barriers between banks, brokers and insurance companies in 1999. At the same time, regulators have forced American banks to meet some of the toughest capital requirements in the world. For their part, bankers have got better at banking—which is to say, better at information technology, risk management, retailing and marketing. They lend much less to big companies than they did even five years ago. In retail banking, the source of half their revenues, they cross-sell other financial services to customers. They have seen off internet banks by mastering internet banking themselves; they may well see off the latest contender, Wal-Mart, too.

Yet alongside all this success, there sits a theory which looks increasingly questionable: that bigger is best. Last year the ten top banks controlled 49% of America's total banking assets, up from 29% ten years before. JPMorgan Chase, the country's third-biggest bank by market capitalisation, has been through 20 mergers and acquisitions in the past 15 years.

Slim down for the tough time ahead

Like many size-obsessed industrialists of yore, the banks insist that market share and economies of scale are all-important, but their shareholders are more ambivalent. Citigroup, America's biggest bank holding company, has underperformed the stockmarket over the past five years. So has JPMorgan Chase. Another monster bank, Bank of America, has done better but is still valued at less than the sum of its parts. All those mergers take time to bed down. And there is also a worry that the biggest banks are testing the limits of manageability. Size and complexity makes them hard to understand and to control from any one centre.

Last year the Federal Reserve Board told Citigroup to suspend further big acquisitions, when some of its controls had seemed to have gone awry. The Fed rescinded the order last month, satisfied that Citigroup had righted itself. But this shot across the bows was surely well timed. Bigness may be a competitive advantage, but only up to a point, and banks may well find they have passed that point—especially if markets lurch and an asset class or two blows up in their faces.

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Scotland

A lament for Scotland

May 18th 2006
From The Economist print edition

Scotland is held back by outdated ideas and English generosity; but home rule has kept the Kingdom United

Get article background

IT IS seven years since Scotland regained a parliament in Edinburgh, one of the odder consequences of the collapse of communism in Europe in 1989. The decision to give Scotland a measure of home rule after an interval of 292 years was not, it is true, directly attributable to the fall of the Berlin Wall. But all over Europe stifled nationalisms—tribalisms, if you will—began to stir once the Soviet threat was lifted. In the east, including the Soviet Union itself, old states were broken up or overthrown. In the west governments dropped their shoulders and seemed to say, “Oh, all right, no harm in throwing these yapping dogs a bone.” In Scotland, the bone has now been chewed for long enough to see that this is unfinished business.

That will come as no surprise to the many doubters, be they unionist Englishmen, Castilian Spaniards, Garibaldian Italians, diehard Russians or kill-hard Yugoslavs, who have long said that any devolution of power weakens the central state and ends in bust-up. Throw these autonomy-seekers a bone, runs the argument, and they will ask for another, and another, until they have the whole cow. If the cow is what a clear majority want, runs the sensible rejoinder, and if the handover is friendly and fair, then so be it: states are there to serve their citizens, not vice versa.

The story of devolution in Scotland, though, is not a story of creeping break-up. As our article suggests, home rule seems to have neither intensified nor diminished the desire for independence. It has coincided with a strengthening in the Scots' feelings of “Scottishness”, and also the growth of an unattractive, albeit mild, Anglophobia. Scotland's self-absorption, self-doubt and lack of sparkle are even more lamentable. Yet the English are no longer blamed for all the Scots' ills. Though the Edinburgh parliament is treated by many as an expensive monument to futility, it, not Westminster, is the first place to feel the lash of Scottish tongues.

No representation without taxation

For both critics and supporters of devolution this must count as a success. A change of power at Westminster, where Labour rules, just as it does (in coalition) in Edinburgh, may one day bring cross-border conflict. But for the moment an irritant has been removed. The same cannot be said of another long-standing feature of Scottish politics: the large role of the state, and with it the culture of dependency that sometimes helps to make the land of Adam Smith look more like yesterday's East Germany than today's Ireland or Estonia. Familiar problems of post-industrialisation and remote regions may excuse some of the spend-and-hand-out activism of the new parliament. The attitude that underlies it, though, is certainly reinforced by the arrangements—an annual block grant from London, calculated according to a mysterious formula—by which the Scottish Executive gets its money.

Scotland's parliament will never look like a serious legislature, let alone behave like one, until it is responsible for raising the money it spends. The principle of no representation without taxation is resisted by governments in London, because they like to control both revenue-raising and public spending throughout the realm. Yet they too now have a reason to think again. The formula for calculating Scotland's block grant is meant to result over time in all parts of the United Kingdom getting roughly the same spending per head, but at present it favours the Scots and seems set to go on doing so. The English are now subsidising each Scot by about £1,000 ($1,900) per year, and they are beginning to notice it.

They are also noticing some other anomalies arising from Scotland's home rule. One is that Scottish members of the Westminster Parliament can vote on matters that concern everyone in the United Kingdom, but that English, Welsh and Northern Irish MPs cannot vote on matters devolved to Scotland. Another is that the man now running the Home Office at Westminster is John Reid, who answers only to the voters of his Scottish constituency, though his department deals not with Scotland's internal affairs, a devolved matter, but those of England and Wales. Indeed, it sometimes seems that half the cabinet is Scottish—an impression likely to be strengthened if Tony Blair is replaced as prime minister by Gordon Brown, a Scot who often does his best to confirm the truth of P.G. Wodehouse's belief that “It is never difficult to distinguish between a Scotsman with a grievance and a ray of sunshine.”

Make Britain tidy?

The United Kingdom's constitutional arrangements have never been neat, and England's voters do not seem to be hugely upset by the Scottish anomalies. But these are not the only bits of business left unfinished by Mr Blair's constitutional changes. The House of Lords is half reformed, stuffed with many appointed members and a few hereditary ones, and operating with uncertain rules of engagement, no clear role and dubious legitimacy. After a botched attempt to separate the executive from the judiciary, a supreme court is being set up as a new British court of ultimate appeal.

The Welsh now have a National Assembly that they seem to like. The Northern Irish have one too, when the province is pacific enough to allow it to open its doors, as it did again this week. Various bodies have been foisted on the English regions, which have also been offered assemblies (no takers so far). And on top of all this come a variety of voting systems for different elections, directly elected mayors in some cities and a human-rights act that allows judges to declare a statute incompatible with the European Convention on Human Rights. This last act, like the devolution legislation and the 1972 European Communities Act, comes close to being fundamental law.

These piecemeal changes amount to quite an upheaval: Britain now has a semi-codified constitution. You do not have to be obsessed with tidiness to see the case for considering all the innovations together in a constitutional convention. But two lessons can already be drawn. First, those who spend should also tax. Second, devolution does not inevitably lead to break-up. To that extent, all those who fear local tribalism should draw comfort from the Scottish experiment.

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On Egypt, French trade unions, oil companies, cannabis, China, EU constitution, Italian

May 18th 2006
From The Economist print edition

The Economist, 25 St James's Street, London SW1A 1HG
FAX: 020 7839 2968 E-MAIL: letters@economist.com

Egypt's challenge

SIR – Egypt deeply regrets any violence that pits its fellow citizens against one another ("Broken promises", April 22nd). In the wake of the recent incident in Alexandria, the government has reaffirmed its commitment to guarantee the security and rights of all Egyptians regardless of their religious or racial background, and stands firmly with others in promoting tolerance and unity among peoples. But even the most established democratic regimes are blighted by social ills. To blame these problems just on government overlooks more complex factors.

You also suggest that possible government interference disabled the leadership of the Wafd Party. Sadly, Wafd has been in decline for years. In last February's *Country Report*, your sister company, the Economist Intelligence Unit, recorded the climax of this process when the Wafd committee voted to remove their incumbent leader, Noman Gomaa, from office. It seems unrealistic to attribute such deep-seated internal party difficulties to government doing.

Third, you lament that emergency laws in Egypt have not been repealed in line with an election promise. Egypt is facing turbulent times and is regrettably afflicted by the scourge of international terrorism. We are conducting a similar debate to that in Britain on the best way to respond. Our new parliament, which sat barely four months ago, should be allowed more time to agree on the appropriate legislation.

Ayman Alkaffas
Press counsellor
Embassy of Egypt
London

French trade unions

SIR – You rightly point out that despite a low level of membership, trade unions in France retain a strong influence thanks to legal arrangements ("Power without responsibility", April 29th). This is because an important piece of legislation states that the outcome of negotiations conducted between employers and trade unions automatically apply to all firms in the same industry. Thus nearly all employees in France are covered by collective negotiations, and the trade unions are in fact defending the interests of the many, not the few.

Emmanuel Gastard
London

Slippery customers

SIR – To suggest that it is only the state-run oil companies, such as Venezuela's, that are inefficient and politicised is naive ("Oil and hauteur", May 6th). The implication that the American-based, multinational oil companies are not themselves highly politicised is nothing short of laughable. Indeed, it is indisputable that they presently have their own operatives holding many levers of power in the world's most important government. In that context it would be irresponsible for a democratically elected leader, such as President Chávez, not to take political steps to protect the interests of his constituents.

Glyn Carver
Chicago

Medical marijuana

SIR – The Food and Drug Administration's inter-agency statement that smoked cannabis has no acceptable medical use in treatment in America, is based on rational scientific mechanisms for prescription-drug approval ("Reefer

madness", April 29th). To date, no drug has been approved in its leaf form because plants contain a complex composition of compounds with uncertain pharmacologies, metabolisms, side-effect profiles, toxicologies, drug interactions, and no control of relative concentrations. There is also strong evidence that cannabis has psychoactive effects on perception and mood, has a high potential for abuse, and can incur addiction and withdrawal symptoms. The 1999 Institute of Medicine report concluded that "if there is to be any future of marijuana as medicine, it lies in its isolated components, the cannabinoids and their synthetic derivatives." By analogy with coca leaves, research and development created local anaesthetics with no psychoactive or addictive properties. Current cannabinoid research shares this goal. Encouraging the view that smoked plants are acceptable forms of medication harkens a return to pre-scientific pharmacology.

Bertha Madras
Deputy Director
National Drug Control Policy
Washington, DC

SIR – Thank you for seeking to disentangle cannabis, medicine and politics. It is a pity no one in a position to do anything about it, will do so, but this person with multiple sclerosis is most grateful for your sterling efforts.

John Major
Leamington Spa, Warwickshire

China's biggest problem

SIR – Despite the supposed openness of the last two decades, China remains an Orwellian state where thoughts and words are monitored by Big Brother and punished when deemed inappropriate by the authorities ("The should-list to discuss with Mr Hu", April 22nd). Yet, the world continues to dance around China because of its economic advancement. When will we stop being dazzled by the impressive coastal cities and gleaming towers of commerce—the façade of an open and modern country—and see China for what it really is: a dictatorship with no regard for democracy or the human person?

Patrick May
Vancouver, Canada

SIR – China's human-rights record certainly deserves the world's attention but so too does its impact on the environment. China's breathtaking economic growth—the main reason for its increasing political influence abroad—and attendant fossil-fuel consumption are having serious consequences. Beijing already famously suffers from dreadful air pollution.

Unfortunately, America is no great respecter of the environment either. So, the question remains: which country has the influence and credibility to question Chinese politics?

Martin Schneider
Geneva

EU constitution

SIR – The list of reasons for renewing the debate on the European Union's constitution was impressive, but incomplete (Charlemagne, May 6th). Once Bulgaria and Romania have joined the EU, no further enlargement will be possible on the basis of the Treaty of Nice. That treaty's abstruse system of voting rights within the European Council, as well as its provisions for allocating seats for the European Parliament, is based on an EU of 27 member states. Once Croatia is ready to join, possibly by 2009, the EU will lack a firm legal basis to admit that country. Those who would like to see enlargement continue should welcome the reopening of the constitutional debate.

François Heisbourg,
Fondation pour la Recherche Stratégique,
Paris

Proper Italian

SIR – The crosshead that you wrote above the letter from Roger Smith about a quote from Dante shouldn't have read "Proper Latin" (May 6th). The quote in question came from the "Divine Comedy", which was written in Italian.

Stefano Moia
Brussels

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Devolution in Scotland

Home truths about home rule

May 18th 2006 | EDINBURGH
From The Economist print edition

Devolution has not brought Scotland's separation. Nor has it brought confidence, self-reliance or a new Scottish Enlightenment

Getty Images

Get article background

"AE FOND kiss and then we sever." In 1999, when Scotland regained a parliament of its own, many believed that Robert Burns's love song was about to become a prophecy. Nationalists hoped, and unionists feared, that their country was now on its way to breaking all ties with the rest of the United Kingdom. It has not happened. Instead, something much less expected has come about. Scotland has regressed into an inward-looking, slightly chip-on-shoulder, slightly Anglophobic country with no clear sense of direction. Instead of gaining a new self-confidence, it has gained self-doubt, while clinging to an old dependency on the state, which still means, at least in part, England.

"Nonsense," or perhaps "Havers," you will say. The new parliament, known as Holyrood, is up and running, a model of participatory democracy with an excellent system of committees, one of which even hears individual petitions. It has passed laws giving free personal care to the elderly, free nursery places to three- and four-year-olds, free bus travel to pensioners—and central heating, too. At the same time it has abolished tuition fees for university students, brought in a fairer voting system for local government, reformed land tenure and set up a mental-health system that could never have emerged from Westminster, where time for Scottish legislation was always in short supply.

Holyrood is a welcoming, bottom-up place, quite unlike the United Kingdom Parliament with its antique conventions, forbidding procedures and officers in 18th-century outfits. The Scottish Parliament is worker-friendly too, and not just for men: two-fifths of its members are women.

True, the building's expense has given devolution a bit of a bad name. The first estimates were £10m-40m ($16m-64m), but the cost rose like a startled snipe, to an incredible £431m at its opening in 2004. In time, though, that may become less of an issue, despite the descent of a beam in March that nearly wiped out the Tory delegation and closed the debating chamber for two months. In any event, the 700,000 people who visited the parliament in its first year testify to the curiosity about, if not the popularity of, the strange edifice at the bottom of the Royal Mile in Edinburgh.

Scold and spend

Yet, if that is the case for the defence, it is not the whole story. In its seven years' existence, the parliament, or at least the coalition of Labour and Liberal Democrats who run the Scottish Executive, has been slow to tax, quick to spend, and even quicker to ban. Its powers of taxation are limited: it can vary the rate of income tax, up or down, by three pence in the pound, and it can change local property taxes for businesses (rates). It knows that to raise

income tax would be unpopular and as yet it has no need to: the money it spends is allocated by the Treasury in London out of general revenues, and distributed according to a rule known as the Barnett formula.

Yet the propensity to spend is strong. Almost everything that the parliament has done to distinguish itself from its London counterpart has cost money, and its two main innovations may well be unsustainable: waiving student tuition fees means compensating universities (or assuring them an ever-sinking status), and free care for the elderly is a terrifying blank cheque in a country whose pensioners are expected to increase by 35% (to 1.3m) in the next 25 years, while those of working age are forecast to fall by 7% (to 3m).

Scotland's politicians, however, have been more interested in settling some old class-war scores than in shrinking the state. One of their first priorities was to ban hunting (embarrassingly, Lord Watson of Invergowrie, the Labour member whose acute sense of morality prompted him in 1999 to introduce the bill, was last year given a prison sentence for arson committed in an Edinburgh hotel after the Scottish Politician-of-the-Year awards).

Then came land reform, largely directed at “feudal” landowners. Some aspects of the legislation were good: the laws of access were clarified. Some were bad: crofters (hereditary tenants of small farms), many of whom live and work in distant cities, now have the right to buy not only their croft but also any fishing and mineral rights, so long as they form a “community”, even if the landowner has no wish to sell. Some will have unintended results: the changes designed to increase the number of tenancies for farmers are having the opposite effect. None will save money: the purchase by their inhabitants of islands such as Gigha under new right-to-buy laws has largely been made possible by huge grants from the taxpayer.

The ban on smoking in indoor public places, introduced at the end of March, falls into the nanny-state, not the class-war, category. It is, however, equally typical. Self-government has not merely brought an 18% increase in employment in the Scottish Executive's main departments and a 40% increase in jobs in quangos, it has also brought a flurry of new regulations. Tourists who struggle all the way to Orkney in the far north to visit Maeshowe, a remarkable neolithic tomb, may, for instance, find it closed by Historic Scotland because of “high winds”, even in August. The production of red tape—the issuance of statutory instruments provides a good proxy—far outpaces that of Harris tweed.

Almost everything that the parliament has done to distinguish itself from its London counterpart has cost money, and its two main innovations may well be unsustainable

Banana-skin republic

The new parliament has not pulled all the best, or even best-known, Scottish politicians back home. Only about a score returned from Westminster, and they did not include such Labour luminaries as Tony Blair, Gordon Brown, Robin Cook, John Reid or Alistair Darling. Donald Dewar was an exception. His early death robbed Holyrood of its first premier—known as “first minister”—and one of its few members who was widely admired. Scandal, albeit a small one over expenses, claimed his successor, Henry McLeish. The present incumbent is Jack McConnell, the only one of the three not to have served at Westminster. A product of local government—which, especially in the west, is richly peopled in many minds with “numpties”, ie, bone-headed placemen—he has conspicuously chosen not to give ministerial jobs to several capable colleagues.

Mr McConnell, too, has been caught up in controversy—scandal would be too strong a word—for failing to declare as an “interest” a brief holiday with a well-known television presenter, Kirsty Wark, and her husband in their villa in Majorca. In truth, the episode revealed more about Ms Wark and the small world of the Scottish establishment, often known as the Scotia Nostra. Ms Wark, it turned out, was a woman of many parts: fearless public-interest inquisitor on the telly, old friend of the first minister, founder of a company chosen by BBC Scotland to make a film about the new parliament building, and member of the panel that had originally selected its design. Fancy.

Scandal, though, has not been an all-Labour affair. Revelations about expense claims swept away the Tory leader, David McLetchie, last year, adding to the widespread disillusionment about devolution. Opinion polls* taken over the first few years of the parliament's life show the slow dashing of hopes since 1997, when 74% of Scotland's voters gave it their blessing in a referendum. Today criticism of Holyrood and the goings-on within is rife. Letters to the press reflect the mood. “Is it not ironic”, ran a typical one recently, “that Scots have travelled the world and made their mark on politics... But when it comes to running our own affairs we make such a mess of it.” The author only just stopped short of comparing Scotland to a newly independent banana republic.

Feelings might be more favourable if the economy were stronger. It is by no means dismal. Last year, indeed, it grew at 2.1%, faster than its long-term average of 1.7%, and unemployment fell. Banking and financial services flourish in Edinburgh's New Town, and by the airport the Royal Bank of Scotland has built a huge headquarters for its global business. Oil-related activities have brought prosperity to Aberdeen and other parts of the north-east. Video games, spun off from Abertay University, are a new industry for Dundee and biotechnology is now well established in Glasgow, Dundee and Edinburgh—home of Dolly the sheep.

The new parliament has not pulled all the best, or even best-known, Scottish politicians back home

But Scotland's annual economic growth rate over the past ten years has on average lagged behind the United Kingdom's by almost a percentage point, and no forecasters expect it to catch up soon. Gloom has settled over much of Silicon Glen—Scotland's technology industry—as many of its manufacturing jobs have gone to lower-cost countries, and fewer Scots now see salvation in foreign investment.

What part has devolution played in all this? Researchers at the University of Strathclyde's Fraser of Allander Institute say Scotland's economy is doing better than would be expected on the basis of its past relationship to the economy of the United Kingdom as a whole. They do not, however, know whether this is attributable to Holyrood. Moreover, even if it is, the improvement is not big enough to make much difference to the most intractable of the country's economic problems, the decline of mining and heavy industry, especially in and around Glasgow.

If Scotland is poorer than England, the west of Scotland is also poorer than the east. The evidence is less clear in the income figures, though, than in the health statistics. Scotsmen in general can expect to live to only 73.8 years, about three years fewer than Englishmen. In the Calton district of Glasgow, male life expectancy is even lower: 53.9 years, almost ten years fewer than in Bangladesh. Scotland has the highest death rates in the United Kingdom from lung cancer, bowel cancer and cirrhosis of the liver. Its childhood obesity rates, at 19% for 12-year-olds (another 17% are merely “overweight”), are higher even than America's.

Surprisingly, perhaps, only 9% of adults in Calton are unemployed, yet 58% do not work. In other words, the majority live off the state. But then the state plays a large part in Scottish life. It spends half of GDP and employs one Scot in four (one in five in England). The public sector is not large by the relevant OECD standards. And by the standards of some other small, rich countries whose governments spend a similar share of GDP, Scotland's growth rate is respectable. But not more than that.

Something of a debate has been taking place recently about the size of Scotland's public sector: is it too big, does it crowd out private investment? Academics, journalists and businessmen have leapt into the fray, but few politicians seem interested, perhaps because so many see their job as simply responding to popular demands. This may reflect the background—typically public-sector—of those who lead them.

Opinion surveys suggest that Scots stand politically a bit to the left of others in the United Kingdom, though only a bit. They vote for parties, though, that are well to the left. Labour, strongest in the western part of the central belt, is rooted in backward-looking state socialism and tends to be Blairite only in paternalistic ways. The Liberal Democrats, perhaps the biggest winners so far from devolution, have prospered not by espousing self-reliance and a bonfire of controls but by pushing free care for the elderly and an end to tuition fees.

The Scottish National Party (SNP) is the big loser. Once the party of the young, upwardly mobile and aspirational, it is increasingly associated with the not-so-young on their way down, says Lindsay Patterson of Edinburgh University. Its tactics seem to be to try to outflank Labour on the left, where it competes with a periodically feisty Scottish Socialist Party.

Only the Tories can plausibly claim to be right of centre, but they have yet to recover from Margaret Thatcher's legacy. Never endorsed by Scottish voters—the Tories last carried Scotland in 1955—her policies so infuriated the Scots that the party won no Scottish seats at all in the 1997 Westminster election. The present Scottish leadership seems terrified of any discussion of taxes, certainly of cutting them.

If Scotland is poorer than England, the west of Scotland is also poorer than the east

The strongest factor that prevents politicians' minds from turning to the size of the state, however, is the fact that they do not have to raise the money to pay for it, or even the 60% of government spending they are responsible for. Over £20 billion simply drops into their hands every year from Whitehall, providing total public spending per Scot of £7,597 (in 2004-05). This is 16%, or £1,034, more than the equivalent figure for the United Kingdom. Scotland's deficit is also out of kilter: net borrowing—which reflects all government spending that benefits the Scots, but excludes North Sea oil revenues—was 13% of GDP in 2003-04, compared with 4% for the United Kingdom as a whole.

Holyrood's politicians can hardly be blamed for this. The block grant gives them the money, and they spend it. They do not overspend; and if they are too lavish on one item they must be stricter on another. They do not, however, suffer the discipline of having to raise their revenue themselves: they are like teenagers on an allowance. And they have no incentive to promote economic growth through taxation.

The case for abolishing the block grant and giving Holyrood tax-raising powers is increasingly being made, most recently by a Liberal Democrat commission under the parliament first's presiding officer, David Steel. Its report, drawing on the experience of other countries, is a happy exception to the parties' generally dull introspection and poverty of thought. But most Scots, if the opinion polls are right, would be pleased to see tax-raising (and some other powers) brought home. For all their disappointment, devolution is still supported by over 50% of Scots—and, incidentally, about the same proportion of English. Few Scots want to revert to the status quo ante.

Brave hearts and barmy history

Wouldn't more powers be another step towards bust-up, a vindication of the Burns-as-prophecy theory? Not really. Polls suggest that, but for one brief hiccup in 1997, Scottish support for independence has remained pretty constant at 25-30%. Devolution, says John Curtice of Strathclyde University, “has to date neither proven to be a slippery slope to independence nor put the nationalist genie back in the bottle.” It has not made much difference to the level of support for separation at all.

Most Scots seem to feel contentedly both Scottish and British. But not all, and not as many as in the past: the proportion of Scots who say they also feel British has diminished since the 1970s, suggest the opinion surveys, and whereas before 1999 only about a fifth of them explicitly said they were not British at all, nowadays the proportion is about a third. Yet, says Professor Curtice, this change is not a continuing slither down a greasy slope, but a single step-change that took place about 1999; and nothing suggests it has come about as a result of devolution.

Devolution, however, has not diminished this sense of being damn-well-not-British, nor the rising Anglophobia that seems to have come with it. This is difficult to measure, but is regularly attested to among the 400,000 or so people of English birth who live in Scotland (about half the number of Scots who live in England). Many of their anecdotes seem trivial: cheering for English teams' opponents during sporting events, complaints about the television coverage given to cricket matches, children bullied at school for being “English”, roars of audience approval whenever William Wallace kills an Englishman during the xenophobic and historically preposterous film “Braveheart”. Individually, these incidents seem harmless—and should not be exaggerated—but taken together they may suggest something more disturbing. One writer, Colin McArthur, certainly finds the political appropriation of “Braveheart” by the SNP troubling, and the film's appeal to “the proto-fascist” psyche particularly so.

Many Scots abhor the “Celtic whinge”, among them, for instance, Andrew Wilson, a former spokesman on finance for the SNP. In 2002 he urged his countrymen to support England in the football World Cup—Scotland had failed to qualify—and wrote, “None of Scotland's problems are the fault of England or the English. All are of our own making,” adding that Scotland had to lose the national chip on its shoulder about the English.

Devolution has not diminished this sense of being damn-well-not-British, nor the rising Anglophobia that seems to have come with it

Yet the chip is bigger than that; it is about a perceived sense of victimhood that many Scots seem to revel in. It encompasses, in particular, a set of beliefs about the Highland clearances, a series of evictions 200 years ago in which thousands of Highlanders were swept off the land by their landlords. When, last year, Michael Fry, an Edinburgh historian, dared to question some of the received conclusions about this episode, 23 members of the parliament promoted a motion condemning him for “clearances denial”—and a Labour ex-minister likened him to David Irving, an historian made infamous for Holocaust denial. Unceasing fury about the clearances is now, it seems, essential to being truly Scottish.

Along with victimhood comes a measure of illiberalism, notably on such matters as abortion, homosexuality and sexual offences. From the outset abortion has always been reserved to Westminster, lest the Scots should come under pressure to restrict their inherited rights. But in other social and sexual matters, too, Holyrood's members often show a mistrust, and fear, of their compatriots' views. This is evident from the frequency with which they voluntarily yield their right to pass laws on a particular issue by adopting a “Sewel motion”, a device that explicitly gives Westminster the power to legislate in an area supposedly devolved to Holyrood.

Oddly, a stream of books have been published recently with titles like “Capital of the Mind: How Edinburgh Changed the World”, “The Scottish Enlightenment: the Scots' Invention of the Modern World”, “On the Make: How the Scots Took Over London”, “How the Scots Made America” and so on. Immodest these claims may be, but the (mostly 18th-century) achievements they celebrate are not altogether imaginary. Some other claims—such as that of Mr McConnell, the first minister, that “Scotland could be home to a second Enlightenment this century”—are more fanciful. Little that takes place in his domain gives cause to think it will be soon.

In the arts, fortunately, Scotland continues to flourish, but in politics it shows little originality, exuberance or readiness to experiment, still less to sever. The story of devolution so far is more like “Ae fond kiss and then we blether”—neither dashing nor romantic, but the basis, it should be said, of many a contented marriage.

*The sources for this article are listed here.

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Immigration

Cross-border suspicions

May 18th 2006 | HERNDON, VIRGINIA
From The Economist print edition

Eyevine

George Bush is successfully wooing public opinion to his balanced proposals for managing immigration. House Republicans may block them anyway

Get article background

A GROUP of Minutemen cluster round a radio. George Bush is making a speech about immigration. He is trying to sound tough but coming across, to this audience, as dangerously liberal. “[T]he vast majority of illegal immigrants are decent people,” he says. “They broke the law!” interjects Lisa Turner, the lady who baked the delicious cookies for this meeting of secure-the-borders enthusiasts in Herndon, Virginia.

The president boasts of boosting funding for border security by 66%, and promises to add 6,000 agents to the 12,000-strong Border Patrol by the end of 2008. George Taplin, the burly head of the Herndon Minutemen, makes a hand gesture indicating that he considers this pitifully inadequate. Mr Bush says he will send “up to 6,000” members of the National Guard to the southern border to help out. Mr Taplin makes another hand gesture.

The Minutemen are not, as they are sometimes portrayed, frothing extremists. They may sometimes sit near the border with binoculars reporting illegal Mexicans to the authorities, but they have strict rules against waving guns about or trying to arrest the Mexicans themselves. Their concerns about illegal immigration mirror those of many Americans.

Porous borders, they say, are a security threat. Poor migrants, they believe, drag down wages for the native-born. The ease with which illegal aliens can find jobs, and the negligible efforts the state makes to prosecute those who hire them, make a mockery of the law. And it is not racist, the Minutemen argue, to worry about being swamped by an alien culture.

Whatever the merits of these arguments, they carry political weight. Immigrants are only around 12% of the population, but they have arrived in some areas suddenly and in large numbers. In nine states, the foreign-born population has more than tripled since 1990. Immigration became an issue in Herndon, a prim little town 1,700 miles from Mexico, when the local council set up a centre for day labourers. This coddled illegal aliens, reckoned Mr Taplin, who formed the Herndon Minutemen to protest. The mayor thought he could ignore him. He was voted out this month.

Mr Bush favours cracking down on illegals but also letting more people in legally. The Minutemen want only the first half of that, and take victories such as the one in Herndon as evidence that Middle America prefers their zero-tolerance approach to Mr Bush's more nuanced one. Surveys suggest, however, that most Americans are quite accommodating when it comes to immigration. What is more, Mr Bush is doing a good job of nudging them further

in that direction. Pollsters for CNN interviewed 461 Americans before and after they watched his speech on May 15th. Before, only 42% approved of his immigration policies. Afterwards, two-thirds did.

Mr Bush's most eye-catching proposal—sending the National Guard to the border—is largely for show. They will not be empowered to arrest anyone, and they will be withdrawn after a year or so, as the promised extra Border Patrol agents are trained and deployed. But his other plans for “enforcement” could make a difference, if followed through.

A tamper-proof identity card for foreign workers, complete with biometric data, would tell employers whether those they hire are legal. Currently, they neither know (because documents are so easy to forge), nor care (because prosecutions are so rare). Mr Bush said it was time to “hold employers to account”. Whether he means this remains to be seen, but many Americans seem prepared to give him the benefit of the doubt.

By talking tough, Mr Bush gave himself political cover to promote ways to allow more migrants to work legally in America. He restated his case for a “temporary worker programme” to allow unskilled foreigners to fill jobs Americans shun. And he restated his case for giving those already in America illegally a chance to become legal and a shot at eventual citizenship after paying a fine and back-taxes, learning English, working for several years and staying out of trouble.

It is not clear whether Congress will follow his lead. The Senate is wrestling with an immigration bill that fulfils most of Mr Bush's wishes: it promises tougher enforcement, a guest-worker programme and a path to citizenship for illegals already in America. An amendment reducing the number of guest-worker visas from 325,000 a year to 200,000 passed handily, as did another promising 370 miles of fence along the border. A final bill is expected to get through soon. The hard part will be reconciling it with a House bill, passed in December, which calls for tougher enforcement and nothing else.

Governors of border states, meanwhile, expressed doubts about Mr Bush's plan to send the National Guard down south. In California, Arnold Schwarzenegger said he supported the president's aims but that it “would be a poor use of forces trained for combat” and “a logistical nightmare”. Bill Richardson, a Democrat, said he wanted to know how many guards were coming to his state, New Mexico, and was discouraged that the White House could not give him an answer. He speculated, on CNN's Larry King show, that policy was “being made on the fly”.

For many, perhaps most Americans, the question is not “Should we welcome immigrants?” but “How many?” A moderate influx may be economically helpful and culturally invigorating; a huge one would be disruptive. It is not easy, however, to look at a proposed law and predict how many newcomers it might let in.

Some estimates are extremely high. Robert Rector of the Heritage Foundation, a conservative think-tank, put it at 100m over 20 years if the Senate bill were enacted. His study, released on the same day as Mr Bush's speech, also included a “maximum” estimate of 193m. That figure—equivalent to 60% of the current population—was seized upon by alarmists such as Rush Limbaugh, a talk-radio host, and Dianne Feinstein, a Democratic senator from California.

But cooler heads queried Mr Rector's methodology. Michael Fix of the Migration Policy Institute, a pro-immigration think-tank, said he doubted that the guest-worker programme would expand as fast as Mr Rector assumes, that immigrants would naturalise as quickly, that so few would die or return home, and that so many would bring their parents. Compounded over decades, small changes in assumptions lead to big changes in results. The non-partisan Congressional Budget Office estimates that immigration reform would add a more modest 7.8m people to America's population over ten years.

That population is growing more rapidly than any other rich country's, but this owes more to a healthy birth rate than to immigration. Granted, some of the higher birth rate stems from immigrant fertility. But the melting pot is still bubbling: adult immigrants work, and their children virtually all speak English. A flexible labour market and stingy welfare state ensure that there is no resentful immigrant underclass with time on its hands, as in France. By the standards of most other advanced countries, America is hardly crowded. It has a proven capacity to absorb large numbers of migrants. And its swelling population—the Census Bureau thinks there could be 500m Americans by 2050—means that the next superpower may well be not China, but the United States. Now there's an idea conservatives can applaud.

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State taxes

A squawk from the little man

May 18th 2006 | CHICAGO
From The Economist print edition

The Supreme Court stays out of a battle over state tax breaks

THE contortionists who run America's state governments often twist their tax codes beyond recognition in a bid to attract investments by potential employers. Since the winners from these circus acts are easier to spot than the losers, it is hard to get politicians to break the habit. So a few taxpayers and small-business owners in Ohio, claiming the state's tax rules hurt interstate commerce as well as their wallets, have tried the federal courts instead. On May 15th they lost their argument—just 20 months after scoring a surprise victory in the Sixth Circuit Court of Appeals—when the Supreme Court ruled that they cannot claim to have suffered any specific harm.

The tax breaks that triggered the lawsuit involved DaimlerChrysler, a big carmaker. The company received $280m in tax incentives for investing around $1.2 billion in a new Jeep plant in Toledo in 1998. Whatever their arguments about interstate commerce, the Ohio taxpayers who took this to court reckoned that tax breaks for DaimlerChrysler and others mean higher rates for them. Far more interesting than their complaint, however, is the range of seemingly disparate groups that lined up against it.

That 35 states supported Ohio in the case is hardly surprising; other states use such tax incentives all the time. Nor is it shocking that labour unions joined big-business groups in backing the governments. Large corporations want those governments to compete with each other by giving out tax breaks; and the unions like the straightforward connection between the resulting investments and jobs. But many anti-tax advocates were also fiercely opposed to the Ohio taxpayers' claims. They argue that competition to attract business investment from other places helps to push down state and local taxes.

Although that analysis is probably correct, it is easy to see why many taxpayers are frustrated. The tax competition between states does not help local taxpayers very much if they lose the tax battle within their own state. Ohio is a classic case. Even though the state gives big incentives to investors such as DaimlerChrysler, it is still a high-tax place. Overall, it collects taxes equal to 12% of personal income, according to the Tax Foundation: the third-highest tax burden in America, and more than a percentage point above the national average. Those poor saps, ordinary taxpayers, are the ones who fill the gap between incentives for business and consistently high state spending.

America's states would no doubt have better governance if they would stick to simple tax systems that are broad and fair, and then compete with neighbouring states by deciding how high or low to set their overall tax burden. Those acrobatic politicians, however, would never go for it.

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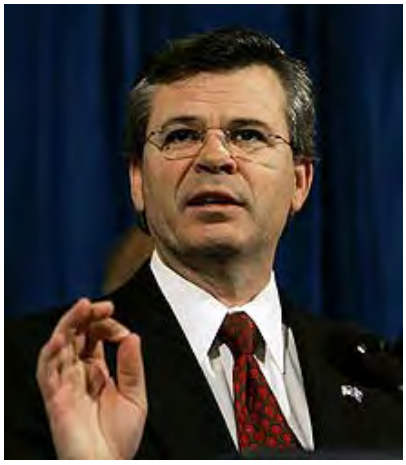
Kentucky politics

Republicans on the back foot

May 18th 2006 | LOUISVILLE
From The Economist print edition

Will the latest scandal help the Democrats? Not necessarily

AP



Fletcher protests his innocence

BOTH Jefferson Davis and Abraham Lincoln were born in Kentucky. That should suggest how wretched and rough state politics can be. True to form, last week the Republican governor, Ernie Fletcher, was indicted on three misdemeanour charges involving hiring policies. Jobs were alleged to have been handed out as political favours: scandalous stuff.

The state of bourbon and moonshine is not famous for honest politicians. In 1994, a former congressman from Kentucky pleaded guilty to bank fraud. In 2003, the then-governor, Paul Patton, pardoned his chief of staff, who had been indicted on campaign-finance charges. Mr Fletcher becomes the third Kentucky governor to be indicted. Last year he issued a blanket pardon to others in his administration facing indictments in the same scandal. (Fourteen more sealed indictments were handed down by the grand jury last week.)

Democrats see an opportunity in the mess. Their party used to control the state, with one stronghold in the unionised eastern coal-mining districts, and still has a majority of registered voters. But as elsewhere in the South, Republicans have dominated recently. Kentucky went heavily for George Bush in 2004, and its two senators are Republican. Mr Fletcher is the first Republican to hold the governorship since 1971, and his party controls the state Senate. Now, with Mr Fletcher and the national Republican Party reeling, Democrats hope not only to reclaim the governorship in next year's election, but also to retake the state Senate and a few seats in Congress. They liken the situation to neighbouring Ohio, where the Republican governor has also been indicted and his party suddenly looks vulnerable.

But Kentucky's Republicans are hardly about to roll over. Mr Fletcher maintains his innocence, and has vowed to run for re-election next year. He claims he is battling a “politically motivated, media-driven investigation” and points a finger at the prosecuting attorney-general, who is believed to be nursing his own gubernatorial ambitions. Larry Forgy, a Lexington lawyer and former Republican candidate for governor, sees a “vast left-wing conspiracy”.

But Mr Fletcher is hobbled by approval ratings that have slumped below 40%. His opponents accuse him of a lack of focus, and point to rising state debt and perennial education woes. Gambling revenues are also being lost to Indiana's floating casinos on the Ohio river, and some think Kentucky, with its tradition of bloodstock breeding, should allow casinos at the race-tracks. Mr Fletcher personally opposes such gambling, but would not stop it.

If Democrats are to re-take the governor's mansion next year, Ben Chandler, a congressman from the rolling horse-farming hills of central Kentucky, may be a contender. He ran in 2003 and lost to Mr Fletcher; part of his troubles stemmed from a sex scandal that swamped Governor Patton, a Democrat.

As for Congress, of the 15 seats the Democrats reckon they need to take it back, it is “conceivable that we could get two or three of those in Kentucky,” says Mr Chandler. The second, third and fourth districts all look vulnerable to Democratic eyes. Republicans scoff: Democrats “haven't got a damn chance in any of them,” says Mr Forgy. November will tell.

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Churches and the Da Vinci Code

Love thine enemy

May 18th 2006 | WASHINGTON, DC
From The Economist print edition

Of heresy and high stakes

Get article background

AMERICA's churches are nothing if not nimble. You might think that they would be up in arms about “The Da Vinci Code”. Dan Brown's novel has sold well over 40m copies in 44 languages; the film version of the novel, which is being released around the world on May 19th, will reach millions more; and yet Mr Brown's message is about as heretical as you can get. “The Da Vinci Code” holds that Jesus was married to Mary Magdalene and fathered a daughter; that the Bible was put together by a fourth-century Roman emperor with a thing against women; that the Catholic Church is a criminal conspiracy.

Roman Catholics are certainly up in arms. The Vatican has urged the faithful to boycott the film. The US Conference of Catholic Bishops has launched a documentary and a website, Jesusdecoded.com. The American Society for the Defence of Tradition, Family and Property is organising prayer-vigils at cinemas. The film is the most flagrant example of American anti-Catholicism, some say, since the Know Nothings of the 19th century.

But many other Christians, particularly evangelicals, are taking a different approach. For them the film provides a golden opportunity to get people talking about Christian subjects. Some churches are giving away tickets along with Starbucks vouchers to encourage post-film discussion. The Campus Crusade for Christ has printed 1m copies of its guide to the code. This Sunday, thousands of preachers across the country will be addressing Mr Brown's book.

One reason why evangelicals are embracing Mr Brown is that shunning proved such a disaster with Martin Scorsese's “The Last Temptation of Christ” in 1988. All the outrage and marches simply made Christians look bigoted and silly, and brought a tedious film much publicity. But there are two more positive reasons.

First, the churches are determined to engage with popular culture. Today's mega-churches have dispensed with traditional hymns and learned sermons in favour of rock bands and—a recent favourite—pastors who preach from inside mock-up prisons, a reference to Fox's hit show, “Prison Break”. The churches did roaring business on the back of “The Passion of the Christ” and “The Lion, the Witch and the Wardrobe”; they hope to do the same, with the aid of a bit of jujitsu, with Mr Brown's offering.

The churches are also obsessed with “seekers”—people who are vaguely interested in Christianity without knowing much about it. The calculation is that the film will boost the number of seekers—and that the churches will then knock Mr Brown's nonsense out of their heads.

Whether Mr Brown's work brings people to God is impossible to say. But with at least 45 books debunking the code, more than a dozen CDs and DVDs coming out with the film, and seven TV specials airing this month, it is bringing a lot of money to a lot of people. Pity about the book.

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Lobbying reform

A tap on the wrist

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Did that hurt? So sorry, didn't mean it to

MEMBERS of the second-oldest profession in Washington, DC, did not need to worry about the “lobbying reform” bill that passed the House early in May. It is a toothless sham. The Senate's version of the bill, passed at the end of March, is a bit less lax, but not much. The two bills will now be painlessly reconciled.

Even the premise of the reform is illusory. The drive for change ostensibly came from the scandal surrounding Jack Abramoff, a mega-lobbyist; but Mr Abramoff was prosecuted for fraud and bribery, which are already illegal. Congress claimed to want to regulate the everyday practice of lobbying. It hardly tried.

For lobbyists, of course, are hugely useful. They are the main conduits for precious campaign dollars. They provide prized intelligence on political strategy. Best of all, they hold out the promise of employment when public service ends. Nearly half of all congressmen who left office between 1998 and 2004 went on to become lobbyists, according to Public Citizen, a watchdog group.

Egregious examples of the revolving door are not hard to find. The Bush administration's chief climate-change official, for instance, was a former lobbyist for big oil companies and recently left the White House to work at Exxon Mobil. Similarly, Billy Tauzin, who headed the congressional panel overseeing the pharmaceutical industry, took the reins of the drug-makers' lobbying group as soon as he left office at the start of 2005.

Under current law, members of Congress and senior aides must wait a year, after stepping down, before lobbying their former colleagues. Even if this “cooling-off” period is extended to two years, as one bill suggests, it will hardly change the behaviour of legislators who know where their next pay-cheque is coming from.

One of the most potent and cunning lobbying tactics of the past decade, grassroots campaigning, will also probably escape oversight. This secretive hybrid of telemarketing, data mining and spin doctoring is used to generate public support for otherwise unpopular corporations caught in a legislative battle. Pharmaceutical companies, for example, tried to fend off regulation of their prices by mobilising black church groups, who were told that the proposed law was racist. Congress is still considering whether to require these lobbying-by-proxy campaigns to disclose their operations, but it is unlikely.

Congress has also had a terribly difficult time deciding whether to curb the lavish trips and free meals that lobbyists hand out. Mr Abramoff famously took lawmakers on a golfing trip to Scotland in exchange for favours. Most lobbyists, showing more subtlety, get their corporate employers to send congressmen, their aides and sometimes their spouses on hundreds of “fact-finding missions” a year, many of them conveniently near a golf course. Senators and leading House members also make frequent use of corporate jets for campaign stops. Neither House nor Senate has touched that.

As for campaign-finance reform, forget it. One of the latest tricks to evade limits on donations is to give money to politicians' “charities” (thinly veiled campaign vehicles), in exchange for promises. Congress is continuing to turn a blind eye to this as well. The House bill merely restricts fundraising by so-called “527” groups, whose money goes chiefly to Democrats.

There is agreement at least on one thing: a mandatory ethics-training course for registered lobbyists and House employees. Congressmen themselves are “encouraged” to attend. As long as it does not conflict with lunch plans, of course.

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Gay rights

An unequal world

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From The Economist print edition

Government workers find benefits for partners are thin on the ground

IF THE partner of Bruce Knotts were a woman, or even a dog, Mr Knotts might not be leaving the Foreign Service, where he has worked for 22 years. But since his partner is Isaac Humphrie, the State Department will not provide him with health insurance (as it does for heterosexual partners) or pay for his relocation to whichever embassy Mr Knotts is sent to (the department pays for relocation of heterosexual partners and pets, though only up to $3,000 for the latter). So, at the end of May, Mr Knotts will be starting a job with the International Rescue Committee (IRC), an NGO that does both.

Mr Knotts's flight to IRC—one of about 8,000 companies and organisations in the private sector that offer domestic-partner benefits—illustrates a growing trend. Private employers, keen to recruit and retain the best workers regardless of their sexual orientation, are providing gay workers with the workplace rights and benefits that the federal government, and many state governments, deny them.

Under the Defence of Marriage Act, passed by Congress in 1996, federal law recognises only marriages “between one man and one woman”. Even in Massachusetts—the only state where, since 2004, gay marriage is legal—a person who marries a government employee of the same sex cannot receive federal health benefits. By the estimate of the government's General Accounting Office, this is just one of 1,138 federal rights and benefits for which only heterosexual married couples are eligible—both on and off the job.

Some states have helped to narrow the gap in workplace rights and benefits between gay and straight workers. For instance, if Coloradans approve a domestic-partnership referendum which the state's legislature has just put on November's ballot, 14 states and the District of Columbia will, by the end of this year, provide domestic-partner benefits to government employees (generally, only gay couples can register with the state as domestic partners). But, on the other hand, 18 states have amended their constitutions to ban gay marriage. And conservative lawmakers in two of these states—Ohio and Michigan—are suing public employers who offer domestic-partner benefits to gay workers on the ground that this violates their constitutions' ban on “marriage-like” relationships.

As well as Ohio and Michigan, nine other states proscribe marriage-like arrangements in their constitutions. Seven more states have anti-gay marriage referendums on November's ballot; in five of them, “marriage-like” relationships would be banned as well. Anti-gay marriage activists in Colorado and Alaska are trying to get referendums on the ballot too.

Even if the courts in both Michigan and Ohio rule that public employers cannot provide domestic-partner benefits to gay workers, “it's very unlikely” that this would mean private employers in those states could not do so either, says Carrie Evans, the state legislative director at the Human Rights Campaign (HRC), a gay-rights group. This means that gay workers' employment opportunities in the private sector should continue to grow. In 2004, Mellon, a consultancy, surveyed a diverse sample of employers—in terms of size, industry and site—and found that, though only 9% of them were legally required to provide domestic-partner benefits to gay workers, 31% of them did, up from 10% in 1998. The HRC reports that about half of the Fortune 500 companies offer them.

Mr Knotts's troubles with the federal government, however, will not end when he joins the private sector. Ask Nancy Frye who, shortly after she married her partner in 2004, enrolled in her spouse's employer-provided health plan. She thought her spouse would not have to pay federal taxes on spousal health benefits; after all, heterosexual married couples do not have to. “I'm not a domestic partner”, Mrs Frye reasoned. “I'm married.” That may be so in Massachusetts, where Mrs Frye and her spouse were married and live. But not under federal law. In early 2005, the IRS notified Mrs Frye's spouse that she would have to pay taxes on the roughly $6,000 her employer spends on her partner's health benefits each year.

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Winemaking

The French touch

May 18th 2006 | WALLA WALLA, WASHINGTON
From The Economist print edition

Some very nice tipples among the wheatfields

DRIVE out of Walla Walla towards the Spring Valley, and the road twists and climbs through nothing but green spring wheat. Here and there a few cattle graze near lonely barns nestled in the draws and dells. Then, suddenly and quite incongruously, there it is: the 44-acre Spring Valley vineyard, the source of some of the finest wines being made in North America.

Vineyards in Washington, which is roughly the same latitude as France, date back to grapes planted at Fort Vancouver in 1825 by the Hudson's Bay Company. Today the state ranks second in wine production, with more than 400 wineries making 18m gallons of wine a year. These numbers are far below California's (nearly 1,400 wineries producing, in 2005, 441m gallons), but what Washington lacks in quantity, it makes up for in quality. Expatriate French winemakers are the secret.

Much of the super-premium action is in the Walla Walla Valley *appellation*, established in 1984. In fact, the first post-Prohibition wineries in the area are all under 30 years old—Leonetti Cellar (1977), Woodward Canyon (1981) and L'Ecole No. 41 (1983) . In 2005, grapes were crushed by 74 local wineries; close to 90 will crush them this coming autumn.

The *appellation*'s reputation for quality was established from the start by superb cabernet sauvignon and merlot from the three pioneering Walla Walla wineries. Other favourites come from the Cayuse Vineyards, where Christophe Baron, originally from Champagne, makes stunning syrah and viognier, and Long Shadows, where a consortium of American, European, Latin American and Australian winemakers produces world-class blends. But these are almost impossible to find. As excellent, but easier to come by, are wines from Spring Valley, Forgeron Cellars, Pepper Bridge, Three Rivers, Fort Walla Walla Cellars, Zerba Cellars and several others.

Marie-Eve Gilla, who came to Washington from Burgundy in the early 1990s and is now the winemaker at Forgeron, says that although she is pleased with many of the wines she has made so far, especially a red blend called “Vinfinity”, she prefers to look five or ten years ahead. By that time, the *appellation*'s young vineyards will have started to mature and their novice managers, some of whom were raised to farm wheat and sweet onions, not grapes, will have honed their skills. Part of the challenge is learning how to control vineyards and quality grape production in a high-desert climate with long, bright summer days and dark, frosty winter nights. But she sees huge local promise, too.

Promise is quite evident at Spring Valley, where Serge Laville, yet another French transplant, pours a barrel-sample from a 2004 cabernet sauvignon and an 2004 cabernet-based blend called “Frederick”. It was not just the quality of Walla Walla's wines that drew him to the new world, he says, but opportunity too: young French winemakers can climb more rapidly in the business in America, and in Washington prime vineyard land is far cheaper than in California.

He allows the young wine to breathe in its glass for a few moments, and then there is a taste. Both the cabernet and Frederick are immediately dense and complex, layered with flavours and aromas as diverse as rose petals, tobacco leaves, pastry frosting and vanilla. Yet they are also elegant; unlike California's wines, they do not overwhelm. Mr Laville smiles. “We all try to put the French touch in our wine”, he says, “but not too much! Because we make wine for the American market.”

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Gastronomy

Fat geese, fatter lawyers

May 18th 2006 | LOS ANGELES
From The Economist print edition

The latest terrain (or terrine?) for lobbyists

HEAVEN, according to one long-dead British clergyman, “is eating pâté de foie gras to the sound of trumpets.” Too bad, then, that it will soon be illegal to get a taste of heaven in the restaurants of Chicago. Appalled by the practice of stuffing food into ducks and geese to make their livers both grotesquely huge and mouth-wateringly delicious, the city council has voted unanimously to make Chicago, from mid-July, the first American city to ban the sale of foie gras. A law passed by the California legislature in September 2004 also bans the production and sale of foie gras, but does not come into effect until 2012.

Will other cities and other states (legislation is pending in Massachusetts and Illinois) follow suit, depriving America's epicures of their sauteed foie gras with figs or their terrine of foie gras with cranberry port reduction? America's three foie gras producers—from New York state, New Jersey and California—teamed up on May 1st with a Canadian producer to form the North American Foie Gras Producers Association and hire a lobbying firm. The California producer, Sonoma Foie Gras, had already launched a lawsuit against Whole Foods, America's biggest natural-foods grocer, charging it with “intentional interference with contract”. This is because Whole Foods told Grimaud Farms of California that it would no longer buy its ducks if Grimaud continued to process foie gras for Sonoma Foie Gras. Grimaud, which says that Whole Foods accounts for 15% of its sales but adds that “many parts of our decision” had nothing to do with Whole Foods, is to stop dealing with Sonoma Foie Gras at the end of this month.

Just how much cruelty is involved in force-feeding a duck is a matter of debate (ducks and geese gorge themselves before they migrate, though not to the extent demanded by foie gras producers). Certainly plenty of other factory-farmed animals have wretched lives. Guillermo Gonzalez, the owner of Sonoma Foie Gras, points out that his 80,000 ducks roam freely for most of their lives and that each force-feeding in their last two weeks takes only a few seconds. Ironically, Mr Gonzalez supports the California law of 2004: it gives him immunity from lawsuits that had cost him $300,000 and time to develop kinder feeding methods.

Meanwhile, as America's top chefs wonder what may be next to disappear from their menus, the foie gras producers' chief lobbyist, encouraged by his experience representing the veal industry, is oozing confidence. The industry is already regulated, he says, and the measures taken by Chicago and California quite simply flout the constitution's protection of interstate commerce: “I've never lost a case in nine years.”

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Lexington

Rove redux

May 18th 2006
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The politics of diminished expectations

KARL ROVE does not have the look of a man who is being downgraded. On Monday he put on a feisty performance at the American Enterprise Institute, a conservative think-tank, batting statistics back and forth, joshing with reporters ("I love watching you on television") and, the real order of business, praising his boss as a great economic reformer. But he is being downgraded nevertheless.

Not in the sense of losing formal power. The recent announcement that Mr Rove is surrendering his "policy portfolio" in order to concentrate on "politics" set tongues wagging inside the Beltway. Surely this was a sign that George Bush's new chief of staff, Josh Bolten, was intent on marginalising a rival? But Mr Rove's power stems from his personal relationship with Mr Bush, not from a mere job title. And the notion of a distinction between "policy" and "politics" in this most political of White Houses is risible. Only one bit of domestic policy matters in the next few months—preventing the Democrats from taking over one or both Houses of Congress. And Mr Rove is in the thick of it.

His legal problems, too, remain as hot as ever. Mr Rove has lived for months with the possibility that he may be indicted for "outing" an undercover CIA agent. He has appeared before a grand jury called by Patrick Fitzgerald, a zealous federal prosecutor, no fewer than five times. It is true that Mr Fitzgerald may be about to wind up his investigation. It is also true that speculation is reaching fever pitch (a recent claim on truthout.org that Mr Rove had already been indicted sent the political world into a frenzy). If Mr Rove is indeed indicted, he will be dumped and leave the White House immediately; if he manages to escape indictment, he will have a weight lifted from his shoulders.

Mr Rove is being downgraded in a much more ego-crushing way than any of this. He was nicknamed "The Architect" after he pulled the 2004 election victory out of the hat. But Mr Rove always wanted to be more than the designer of a couple of election triumphs. He wanted to build a permanent political realignment—to do for the Republicans what Franklin Roosevelt did for the Democrats. He wanted to use the culture wars to turn socially conservative blacks and Latinos into Republicans, and use Social Security reform to entice young people into the Republican fold. And he wanted to use the Medicare prescription bill to buy support among the growing crowds of the elderly.

But rather than overseeing an electoral realignment, he now has to try to avoid a looming electoral meltdown. How many blacks are likely to vote Republican after the Hurricane Katrina fiasco? And how many Hispanics are likely to do so now that Congressman Tom Tancredo and other nativist Republicans have advocated felonising illegal immigrants and keeping them out with a wall? Mr Rove's job is no longer to extend Republican power. It is to prevent conservative activists from abandoning the party in November. Polls suggest that Mr Bush's support is hovering at about 50% among conservative Republicans, a good 30 points below where it was in 2002. Yet turnout

among hard-core activists is vital to success in the mid-term elections.

Mr Boob-bait

The president's trusted Svengali is thus in a doubly odd position. He is being forced to spend most of his time reconverting the once faithful. He and his boss are serving up red meat in the form of extending the tax cuts (which got through Congress last week) and nominating conservative judges; he has also embarked on a whirlwind tour of speeches and meetings. And he is being forced to tackle problems that he himself created in the good old “permanent majority” days. Mr Rove's strategy was to extend the base by tempting in new groups with various bits of boob-bait such as cheap prescription drugs and immigration reform. But those ruses frequently alienated the base without adding new supporters.

What chance has Mr Rove of winning this new battle and restoring the base? Conservatives are spitting blood at the moment over everything from the $14 billion in earmarks in the latest emergency spending bill, to Mr Bush's “Nixonian” weakness for big government, to his “lipstick on a pig” immigration reform. Newt Gingrich, once the voice of Republican small-government revolution, argues that America is “hungry for conservative leadership”, despite the fact that the Republicans control both houses of Congress and the White House. Other Republicans openly call for defeat in November in order to give the party a boot in the pants.

But much of this is typical conservative hyperventilating—exactly the sort of thing that was heard in the run-up to the 2004 presidential election. Mr Rove still has some wares to sell. Mr Bush has delivered solid benefits to most components of the Republican coalition, including two Supreme Court judges for social conservatives and $1.7 trillion in tax cuts for small-government conservatives. Grover Norquist, the head of Americans for Tax Reform, draws the comparison with his father's presidency: “That was treason. This is disappointment.” Mr Bush's party still has the ability to control the agenda in Washington. And the Democrats are a reliable bogeyman.

This may give Mr Rove just enough to work with. He can also keep base-pleasing measures rolling down the legislative pipe—from an anti-gay-marriage amendment to a vote on the “death tax” to that old favourite, an anti-flag-burning amendment. He can encourage his boss to play the veto card for the first time—and pick a showy fight with Congress over some pork-stuffed spending bill. And he can conjure up images of Democratic committee chairmen paralysing the president and attempting to impeach him. This may allow him to squeak past disaster in November. But there is a big difference between avoiding catastrophe and creating a permanent Republican majority.

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Brazil

The mob takes on the state

May 18th 2006 | SÃO PAULO
From The Economist print edition

A prison gang shows its deadly power and flatfoots the politicians

AP

RIO DE JANEIRO is more beautiful, but residents of São Paulo boast that their city is safer. At least they did until May 12th, when a wave of violence orchestrated from within the prison system struck Brazil's biggest city and several neighbouring towns. In five days of mayhem and retribution some 150 people, a quarter of them policemen, were killed; 82 buses were torched and 17 bank branches attacked. Rebellions erupted at 74 of the 140 prisons in São Paulo state. Schools, shopping centres and offices shut down; transport froze. For several days, *paulistanos* could not even claim that their city was safer than Baghdad.

It was a show of force by the leaders of the state's main criminal gang, the Primeiro Comando da Capital. Directing the violence by mobile phone from their prison cells, they cast sudden doubt on whether São Paulo, the engine of Brazil's economy, is ruled by laws or by the mob. This is sure to be an issue in October's presidential election, which pits the incumbent, Luiz Inácio Lula da Silva, against Geraldo Alckmin. As governor of São Paulo until March, it is Mr Alckmin who has carried the chief political responsibility for its security.

In Rio, it is widely known that three gangs battle each other and the police for control of the slums and the drug trade. São Paulo's drug trade has been more fragmented, and its Primeiro Comando a more shadowy presence. But contrary to some claims, the Comando has gathered strength. It has taken control of drug dealing and infiltrated youth detention centres. It seems to be colonising the criminal underworld, replacing individual initiative with organised enterprise, says Sérgio Adorno of São Paulo's Nucleus for the Study of Violence. That generally requires the connivance of public authorities.

Tulio Kahn, of São Paulo's public-security secretariat, says the Comando's fluid structure is more like al-Qaeda's than that of a tightly-run mafia. Its habitat remains the prisons. Its top boss, Marcola, who began his career, aged nine, as a pickpocket, has been in jail since 1999. His followers call him “Playboy” because of his fondness for designer clothing.

In 2001 the Comando staged a multi-prison rebellion and in 2003 it murdered an unpopular judge. But nothing foreshadowed this week's reign of terror. It proved that the Comando could strike at will, like a well-drilled army, and bring São Paulo almost to a halt. The shock was all the greater because violent crime has been declining. Between 1999 and 2005 the murder rate in São Paulo state dropped from 35 per 100,000 people to 18.

The offensive seems to have been provoked by the transfer of 765 of the Comando's adherents to a more remote jail. An earlier demand was for 60 television sets to watch next month's soccer World Cup. Mr Kahn argues that the Comando may have reacted to a recent crackdown, which included the creation of an inter-agency group to take on the gang.

But the Comando's murderous tantrum also points to something amiss in the way Brazil punishes criminals. The approach is at once unduly harsh and absurdly lenient. Prisoners may be denied television but can use their mobile phones to extort money.

The jails have become more crowded since 1990, when a federal law mandated prison sentences for selling drugs, no matter how small the quantity. São Paulo embraced this with gusto. Its prison population has more than doubled since 1994. But prison building lagged—the system has 35% more inmates than places. Some of the hastily trained guards became prisoners' accomplices. Inmates are supposed to work, study and receive decent healthcare—but many do not. “Prisons are becoming centres of criminality,” says Sérgio Mazina of IBCCRIM, a research institute.

The state government has now brought calm, but is accused of doing so with the same mixture of indulgence and harshness that caused the trouble. It denies reports that it made a deal with Marcola, yielding on the televisions and other privileges. A police counter-offensive has so far killed 93 “aggressors”—hardly an advertisement for the rule of law.

The debate provoked by the Comando's outrages pits popular demands for toughness against pleas for a more nuanced approach to criminals. More sensible proposals include transferring gang leaders to jails out of range of telephone transmission towers. State officials say that the declining murder rate (until this week) shows that incarceration is working. Cláudio Lembo, São Paulo's interim governor, wants to record conversations between prisoners and lawyers, who often pass on messages. The bar association rejects this as illegal. Galvanised by the crisis, Brazil's Congress is considering the creation of an intelligence service to fight corruption in the jails, which might be useful, and the introduction of solitary confinement for up to two years, which might not be.

It would be better to spring-clean the prisons. “A third or fewer prisoners really have to be there,” says Julita Lemgruber, a sociologist at the Universidade Candido Mendes in Rio de Janeiro. If the rest were punished in less drastic ways, they would be removed from the influence of the worst criminals. That would require new laws and more discriminating judges. To fight organised crime, police forces need to become more adept at investigation rather than mere repression.

Do not expect anything but tough talk from the presidential candidates. President Lula left it to an aide to suggest that Mr Alckmin had sown the seeds of chaos. Mr Alckmin slammed the federal government for cutting spending on public security. But at least now neither of them can dodge the subject of crime.

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Latin America's economies

Improving on the Latin rate of growth

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Doing well, could do better—especially on poverty

THREE times in the past quarter-century, Latin America has played a leading role in global financial crises. So when investors around the world dumped risky assets in recent days, it made a refreshing change that Latin American shares, currencies and bonds—although not exempt—were not singled out. That pointed to an economic transformation in the region which has been less noticed than the noisy antics of some of its populist politicians.

Taken as a whole, Latin America's economies are doing better than they have for more than two decades.

In 2004, Latin America's economies grew at an average rate of 5.9%, the fastest rate since 1981, as they finally pulled out of several years of stagnation (or worse in some countries). Though the pace has slowed a little, growth continues (see chart 1). The United Nations Economic Commission for Latin America and the Caribbean expects growth of 4.6% this year. That could be an under-estimate. Barclays Capital, an investment bank, reckons that in the first three months of this year the region grew at an annualised rate of 6%.

In some ways the growth looks more sustainable than in the past. Inflation, after a blip, averaged just 6.3% last year. Except for 2001, when it was 6.1%, that was the lowest rate since the 1960s. The region has had a current-account surplus for the past three years (see chart 2). That is a sharp contrast with 1997, when growth of 5.5% saw a current-account deficit of 4.5% of GDP the following year—the unsustainable prelude to a wrenching round of devaluations and recessions.

Far from increasing its foreign debt, Latin America has used its growth to reduce it. Public debt is down too, from 72% of GDP in 2002 to 53% last year, according to the Inter-American Development Bank. That reflects stronger public finances. The Bank calculates that the average fiscal deficit in the region has shrunk from 3.3% of GDP in 2002 to 1.7% last year.

All these changes have inspired a boom in Latin American assets. Stockmarkets have enjoyed three bumper years, and the risk premiums governments have to pay on their bonds have fallen to record lows. Unless commodity prices collapse and interest rates in the United States rise sharply, the region's economies should sail safely through the current choppiness in financial markets, says Peter West, a Latin America specialist at Poalim Asset Management in London.

The growth has drawn some of the sting from the debate about the so-called Washington consensus, as the liberal reforms of the 1980s and 1990s were known. Whatever the political rhetoric, since the devaluations of 1999-2001, many countries have stuck to sound macroeconomics: flexible exchange rates, inflation targeting by more-or-less independent central banks and fairly responsible fiscal policies.

Sceptics argue that Latin America should be doing even better than it is, given the circumstances. Demand from China and India has seen prices for Latin America's commodity exports rocket upwards. Until recently, low interest rates in rich countries pushed investors to seek rewards in emerging markets. Latin America's growth has outpaced that of the world as a whole. But it falls well short of that of China and India (though these countries are at an earlier stage of their development). Latin America's growth figures are boosted by recoveries from earlier collapses in Argentina and Venezuela. Brazil and Mexico, the region's biggest economies, have performed more modestly.

How to raise this relatively disappointing growth rate is a matter of much debate. One interpretation is that the pay-off from reform is finally arriving, but much later and more gradually than the reformers expected. Investment is creeping up. Exports are becoming more diversified. Low inflation means that interest rates have fallen. Bank credit—long scarce in the region—is becoming more widely available.

Another view holds that Latin America has been flattered by the commodity bonanza and that its economies still suffer from structural weaknesses. Investment averages only around 20% of GDP. It is over 25% in Chile, the region's most consistent performer, where growth has averaged 5.7% since 1990. Mario Blejer, a former governor of Argentina's central bank, notes that foreign direct investment in Latin America is disproportionately low. “There's a lot of fear that the region is becoming politically more risky,” he says.

Much remains unreformed. Productivity is rising only slowly, and rigid labour laws deter companies from hiring workers. Business is hemmed in by costly red tape. According to surveys by the International Finance Corporation, the World Bank's private-sector arm, in Latin America it costs more to start a business than anywhere except the Middle East and Africa; the region is the world's most difficult place to enforce contracts.

Raising the sustainable rate of growth is a long-term task. In the meantime, there are two big challenges. The first is to stay out of trouble if and when the world economy weakens. That points to the need for tighter fiscal policy. Brazil's public spending saddles the economy with intolerable tax and interest rates. Only Chile and Mexico (to a lesser extent) are saving some of the windfall gains from the commodity boom to spend them when times are hard. Contrast that with Venezuela's Hugo Chávez, who is spending his oil windfall as fast as it comes in.

The second problem is enduring poverty and inequality. If many Latin Americans still see the fruits of reform as disappointing, that is because poverty rates do not seem to be falling as fast as they should be (see chart 3). That is partly because income distribution in Latin America is more unequal than anywhere outside Africa.

According to a recent report by the World Bank, widespread poverty can itself be a drag on growth.* The poor cannot take a full part in the economy. That points to giving priority to policies which simultaneously increase growth and reduce poverty. Examples include investment in education and in infrastructure, according to Guillermo Perry, the bank's chief economist for Latin America.

These findings also add an economic argument to the political case for well-designed anti-poverty programmes. In the past few years, several of the region's governments—including those in Mexico, Brazil and Colombia—have started to adopt these on a large scale. Some 50m Latin Americans are now enrolled in schemes which pay them a small monthly stipend in return for keeping their children in school and taking them for regular health checks. There is plenty of evidence that such policies are starting to work. In Mexico, where they were pioneered, extreme poverty fell by half between 1998-2004, despite only moderate economic growth. Contrary to myth, Brazil's income distribution is less unequal than at any time in the past 30 years.

But much more needs to be done to improve access to good quality schools and healthcare. Mr Perry points out that in developed countries, public spending has the effect of reducing income inequality. Not in Latin America, where governments skew spending towards better-off groups through pensions, subsidies for university students and for energy consumption.

Raising the rate of growth in Latin America, and achieving fairer societies, therefore has much to do with reforming the state. Policies matter, but so do the political institutions through which they are approved and implemented, the IADB concluded in a recent report.† Chile's economic success, for example, owes much to political factors—a relatively effective and uncorrupted civil service and judiciary, and a broad political consensus which gives investors confidence that they will not face unexpected policy changes. Economists now recognise that policymaking does not take place in a vacuum. That looks like progress, albeit belated.

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*"Poverty Reduction and Growth: Virtuous and Vicious Circles", by Guillermo E. Perry and others. World Bank Latin American and Caribbean Studies.

†"The Politics of Policies: Economic and Social Progress in Latin America, 2006 Report". Inter-American Development Bank and David Rockefeller Centre for Latin American Studies, Harvard University.

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Ecuador

Grabbing Occidental

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Take the oil money and run

AP

Get article background

RARELY has Ecuador spurned an opportunity for populism. So it was on May 15th, when the weak caretaker government of Alfredo Palacio said that it was taking over the oilfields in the Amazon jungle run by Occidental Petroleum, an American company. That decision will bring a short-term boost to government revenues. But it will have one or two consequences.

Occidental was producing around 100,000 barrels per day of oil, around a fifth of Ecuador's total output. It has invested $1 billion in the country since 1999. The government accused it of having breached its contract by failing to register its sale of a stake in another field—a claim the company rejects. This came on top of a dispute about tax. Occidental said its assets have been expropriated; it has filed for international arbitration.

Last month, Ecuador's Congress passed a law raising taxes on oil companies to 50% when prices go above the levels stipulated in contracts. That looked moderate compared with recent actions by Bolivia and Venezuela. Now, the future of private investment in Ecuador's oil industry looks in doubt. Petroecuador, the state company, will take over Occidental's fields. But it is poorly run; its output is declining. Foreign state-owned firms may be invited in.

That may be a decision for the next president, to be elected later this year. Most of the leading candidates for the presidency support the government's action. Most also say they oppose a free-trade agreement with the United States. So they may have been relieved when the United States' immediate response to the Occidental takeover was to cancel long-running trade talks. But that leaves many of Ecuador's businessmen fuming. Peru and Colombia have both concluded such talks. If trade agreements with those countries are ratified, Ecuador will lose out. But long before then, Mr Palacio will have disappeared from the scene.

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The Dominican Republic

Reform rewarded

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From The Economist print edition

More power for an effective president

THE president, Leonel Fernández, arrived in office in 2004 with his country reeling from a bank failure, an inflation rate above 50% and a sagging currency. Through austerity measures and the force of reputation—the economy boomed in his first term as president, from 1996-2000—he quickly set matters right. The economy grew by 9.3% last year, while inflation was down to 7.4%. Mr Fernández accomplished this by coaxing co-operation from a Congress dominated by the opposition. To turn recovery into sustained growth, he sought a majority of his own in a legislative election on May 16th.

Early results suggested that his Dominican Liberation Party and its allies had won just over half the vote. Even if that fails to translate into a majority in both houses of Congress, Mr Fernández will be in a much stronger position. He has been hobbled by a provision under which the whole Congress is elected midway through the presidential term. In the outgoing Congress, his party had just one of the 32 seats in the Senate and 41 of the 150 in the lower house.

Mr Fernández says he would like to change this system, but winning the necessary opposition approval may be hard. On many big issues all sides agree. These include support for DR-CAFTA, a free-trade agreement with the United States due to come into effect this summer. So the campaign degenerated into name-calling and a contest over who was more credible and less corrupt.

The advantage lies with Mr Fernández. He has been criticised for lacking zeal in prosecuting corruption. But the biggest scandal, a dodgy bank bail-out which triggered the economic chaos, occurred under his predecessor, Hipólito Mejía. Mr Fernández has hitherto been impeded in prosecuting this case by his dependence on Mr Mejía's Dominican Revolutionary Party and its ally of convenience, the Social Christians, for approval of the austerity measures.

The president should now be free to move ahead. He says that sorting out his country's chronic electricity shortage is the main challenge. Most power is generated from expensive imported fuel oil (though some of this comes with a generous subsidy from Venezuela's president, Hugo Chávez). Distribution is also a problem. Many customers, both rich and poor, do not pay for their electricity. The two state-owned distribution companies receive a total government subsidy of $500m a year. Mr Fernández says he wants to reform the industry and end the subsidy.

The government also plans to extend a pilot scheme to tackle drug-related crime. Better prospects for neighbouring Haiti, whose elected president, René Préval, took office on May 14th, may also help to improve security. Wilfredo Lozano, a political analyst in Santo Domingo, notes that Mr Fernández is the only effective political leader the Dominican Republic has at the moment. Just as well, then, that he has a firmer mandate.

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Bolivia

Dreams and realities

May 18th 2006 | LA PAZ AND SANTA CRUZ
From The Economist print edition

The checks on Evo Morales's revolution

AFP

IN THE five months since Evo Morales won Bolivia's presidential election, he has made enough headlines for a five-year term. Since declaring “long live coca and down with the *Yanquis*” in his acceptance speech, he has nationalised the gas industry, signed a trade treaty with populist Venezuela and communist Cuba, and accused Bolivia's judges of “representing the colonial state”. All this seems to place Mr Morales on the extreme wing of Latin America's expanding contingent of leftist presidents. The drift is worrying, but it is too early to conclude that his government will be as irresponsible as his rhetoric.

Mr Morales's indigenous blood and his absolute majority in the election give him unprecedented legitimacy. He wants to reshape Bolivia, but he faces limits. On July 2nd Bolivians will elect a 255-member constituent assembly, charged with drafting a new constitution. Mr Morales has his eye on winning as many assembly seats as possible for his Movement Towards Socialism (MAS). Only in the writing of the constitution will it become clear whether Mr Morales will strengthen or undermine democracy and the market economy.

The government's constitutional proposals are not encouraging. Héctor Arce, an adviser to Mr Morales, says that elected representatives have failed Bolivians. He wants a much greater role for plebiscites and referendums, reserved seats in Congress for indigenous representatives, and no term limits for the president. “A government should be in power for as long as the people want it to be,” he says.

Mr Morales has been chipping away at the separation of powers. He cut public-sector salaries by half, an austerity measure that had the effect of encouraging mass resignations from the bureaucracy and the courts of officials not aligned with MAS. His most ferocious diatribes are directed at the courts and the media. Four of the 12 Supreme Court justices have resigned; the rest (along with the members of the Constitutional Tribunal) decried the president's “assault” on judicial autonomy. Rumours abound of officials harassing unsympathetic editors.

The main check on MAS's constitutional ambitions will come from Bolivia's nine departments, several of which want greater autonomy. Mr Morales supports transferring responsibilities to provinces that want them. But there will be a fight over finances. Santa Cruz, the richest and most autonomy-minded province, contributes 42% of the country's tax revenues but receives just 22% of public expenditure. It hopes to increase its share to 33%, but that would come at the expense of poorer provinces sympathetic to MAS.

Even pricklier is the subject of land. The government this week said it would distribute state land and unused private land to peasant farmers. Under Bolivian law, land that is not used productively for two years “reverts” to the state to be redistributed. No previous government has dared to implement the measure in Santa Cruz, the heart of Bolivian agribusiness but home also to many less-productive landowners, some with dubious title.

Much as Mr Morales would like to seize power from Bolivia's traditional elites, he may not have a free hand. More than one-third of the constituent assembly's seats are reserved for electoral runners-up, and a two-thirds vote is required to approve a constitution. MAS will thus need allies.

Something similar applies to energy nationalisation. The government has temporarily raised royalties from 50% to 82% at the two biggest gas fields. But it will have to settle for less if it is to get the outside investment it needs. Brazil's Petrobras, the biggest investor in Bolivia, has threatened to stop refining in the country. The government now talks of compensating Petrobras with gas. Mr Morales wants to be radical, but reality may yet stop him.

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China

Ignoring the past

May 18th 2006 | HONGSHENG AND ANREN
From The Economist print edition

NB Pictures/Li Zhensheng

Forty years on, the government still avoids discussion of the Cultural Revolution

Get article background

IN THE village of Hongsheng, Li Furong feared trouble when he was summoned one day in August 1966 to a meeting. He had been denounced as a “capitalist-roader” and thought fellow peasants had gathered to attack him. Instead he found himself press-ganged into helping with the murder of octogenarian former landlords in one of the bloodiest orgies of violence in or around China's capital, Beijing, during the Cultural Revolution. Even 40 years later, the authorities are trying to suppress news of what happened in Hongsheng and nearby villages of Beijing's Daxing district.

The Communist Party's unwillingness to confront the horrors of the Cultural Revolution, which was launched on May 16th 1966 and officially ended ten years later with the death of Mao Zedong and the fall of the Gang of Four, means that for Chinese historians as well as for millions of victims that entire period is, in effect, off-limits for debate. The passage of time does not appear to be helping. Chinese scholars say the government has been even more intent on stopping public commemoration of this week's anniversary than it was a decade ago. No mention of it has appeared in the state-controlled media. A group of scholars who held a private symposium in Beijing in March to discuss the Cultural Revolution avoided using e-mail to arrange it for fear their communications would be intercepted by officials.

Partly, it is embarrassment about the scale and brutality of the violence carried out in Mao's name. In Hongsheng, Mr Li, now 75, says village officials told the meeting that former landlords and rich peasants, stripped of their holdings after the Communists took power in 1949, planned to stage a revolt. No evidence was offered. The plan was to kill the alleged plotters and their entire families that night. Mr Li, worried that as a “capitalist-roader” he too would be killed, agreed to use his well-known skills with rope to bind the victims. Two former landlords in their 80s were the first to be dealt with. Mr Li had barely finished his work before the old men were dragged away and beaten to death.

It could have been worse. Mr Li says that, had he not asked the village party chief whether he had written authority for this, other members of the landlords' families would have been murdered that night too. In some neighbouring villages there was much greater bloodshed. The youngest victim was one month old. Bodies were thrown down wells or into pits. In the commune to which Hongsheng belonged, 110 people were slaughtered within 24 hours. This was only one of 13 communes in Daxing district involved in what has become known to locals as the “8/31 [August 31st] massacre”. City officials called a halt to the violence after a couple of brave village officials travelled to the party's headquarters in central Beijing, 35 km (22 miles) away, to complain.

Even today, few in Beijing know anything about this, even though the official death toll, 324, exceeds the conservative government estimate of around 200 killed in the suppression of the Tiananmen Square protests of 1989. A brief mention of the massacre appeared in a book on the Cultural Revolution that was published in 1986 and quickly banned. A detailed government account was published only four years ago in an appendix to the “Daxing County Gazette”, a hefty and little-read tome, but was not reported in any newspaper. Of those killed, the book says, 91 were women. Nineteen entire families were eliminated.

The Daxing killings were part of what some perpetrators boasted of as a “red terror” that gripped Beijing between August and October 1966. Wang Youqin of the University of Chicago says officials have never acknowledged the extent of the bloodshed in the capital. She says that Red Guard mobs, obeying Mao's exhortation to “be violent”, killed some 2,000 Beijing residents in the space of two weeks.

One reason for the government's reticence is that, during this stage of the Cultural Revolution, many Red Guard leaders were the offspring of high-ranking officials who were subsequently purged but who became powerful again after Mao's death. Perpetrators of the violence were barred from influential positions after Deng Xiaoping took control in 1978. But Ms Wang says their family connections often protected them from punishment. The “Daxing County Gazette” says 348 people were “directly responsible” for the murders there, nearly two-thirds of them party members. Only 38 were jailed, the longest for 12 years. Pardons were granted to 246.

Officials fear that closer scrutiny of the Cultural Revolution could destabilise the country by inflaming long suppressed antagonisms. Many scholars now believe that well over 1m were killed or driven to suicide in political struggles between 1966 and 1976. The lives of almost all urban residents were profoundly disrupted. Schools and universities were closed. Educated people were forced to leave cities and work on farms. Family members turned on one another. Many of those now in their 50s belong to a “lost generation” whose education and careers were permanently blighted by the Cultural Revolution.

In 1981 the party leadership issued a long denunciation of the Cultural Revolution, as well as various other “mistakes” made by Mao, though these were portrayed as secondary to his contributions. The “Gang of Four” led by Mao's wife, Jiang Qing, who were deemed responsible for the Cultural Revolution's atrocities, were given lengthy prison terms (the last of the four died in December). Most of those persecuted were officially “rehabilitated” by the early 1980s.

There is, however, no official memorial to the victims. Appeals by some intellectuals for a museum dedicated to the events have gone unheeded. In recent months, private funds have started to remedy this. Last year, a privately run Cultural Revolution museum opened near the coastal city of Shantou in southern Guangdong province. In Anren township, near Chengdu, the capital of the south-western province of Sichuan, a wealthy real-estate developer, Fan Jianchuan, says he is preparing to open another later this month.

These ventures are still modest. The one in Shantou shows pictures of officials and other prominent figures being persecuted, but otherwise sticks to the government line. Mr Fan's will concentrate at first on porcelain artefacts from the period. His vast and lavishly designed complex, opened last year, is already home to a remarkable display of historical daring: a whole building of exhibits concerns the (positive) contribution of the Kuomintang, China's then ruling nationalist party, to the war against Japan. In Communist Party histories the Kuomintang is portrayed as having shirked the war.

But Mr Fan has no plans to display objects relating to the Cultural Revolution's factional warfare and other violence. “It's not just that I'm too cowardly and don't want trouble, but I also think it wouldn't be good for the peace of society,” he says. He may perhaps do so in 20 years.

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Japan

Ikonoclast

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Debating issues in Japanese politics? What a droll idea

TARA KONO, a vice-minister and member of the ruling Liberal Democratic Party (LDP), points out a dispiriting feature of the race to succeed Junichiro Koizumi as prime minister in September: none of the potential candidates is talking about the issues that really matter to voters. Mr Kono has a point—especially about pensions.

In Japan, as in most developed countries, the pension system works by taking contributions from those in work to pay for those in retirement. This works fine with a growing population. But Japan's population is now falling, and the proportion that is over 65, at 19.5%, is already the highest in the world. That figure will reach nearly 30% by 2025, as Japan's post-war generation of baby-boomers is now starting to retire. The number of younger people is also falling fast, meaning fewer workers supporting ever more pensioners.

The government has taken a few steps to deal with the problem. The pension system has two parts. The contributions that employees and employers make to the earnings-related part will go up a notch each year until 2017, and the minimum mandatory retirement age will rise from 60 to 65 between 2013 and 2025. Contributions to the basic state pension, available to everyone, will also go up; the monthly mandatory contribution of ¥13,860 ($126) is to be raised by ¥280 each year until 2017.

If you think that will solve the problem, says Mr Kono, then you are at odds with the millions who are abandoning their obligations to the system. Currently over 36% of Japanese are not paying contributions towards the basic pension, and the number is growing. The proportion is over 50% among those aged 20-24, and who can blame them? The system will be bankrupt by the time they come to draw on it. So Mr Kono proposes scrapping the contribution system and funding the basic pension out of a consumption tax, with the wealthiest retirees not eligible for benefits.

Another dispiriting feature of the leadership race is that, instead of taking their case to the country, potential candidates are lobbying behind the scenes to get the backing of the LDP lawmakers who will vote for a new party leader. So, unexpectedly, Mr Kono last week declared his candidacy, one built on solid policy issues, pensions to the fore. He thinks he can change the nature of the race.

“Any new leader”, he says, “has at least to come forward and say what he proposes to do.” Yet none of the four preferred candidates has definitively said he is even running, partly because each has been trying to sew up the backing of the LDP's nine organised factions. Traditionally, factions support just one candidate. A problem for the Mori faction, the biggest, is that two of its prominent members, Shinzo Abe and Yasuo Fukuda, seem bent on running.

Mr Kono, a stripling at 43, is also a member of a faction. Indeed, it carries his name, or rather that of his father, the speaker of parliament's lower house. Meanwhile a senior member of the faction, none other than the foreign minister, Taro Aso, is also expected to run for the leadership. Who cares, says Mr Kono. Factions have lost their main point since multi-seat constituencies were abolished in favour of single-seat ones in 1996. In 2001 Mr Koizumi broke the factions' hold on the political process by refusing to defer to them when appointing his cabinet, but he did not go far enough. Mr Kono says he will kill off factions altogether, by depriving them of their remaining ability to appoint members to powerful committees and as vice-ministers, like himself. After that, not even the factions' weekly ritual, the Thursday lunch, would have much point.

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Indonesia

Yudhoyono, world statesman

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From The Economist print edition

Indonesia's president boldly steps into the world's diplomatic minefields

WHEN President Susilo Bambang Yudhoyono took office in October 2004, he promised to spend his early months concentrating on Indonesia's severe domestic problems. Now in the second year of his mandate, Mr Yudhoyono is apparently finding that tackling poverty, unemployment, endemic corruption, militant separatism and Islamist terror is no longer enough to keep him busy. He has started to strut the world stage.

AFP

Ahmadinejad resists Yudhoyono's charms

In recent months he has offered to mediate in the Israeli-Palestinian conflict and in Iran's nuclear confrontation with the West. He has also visited Myanmar's junta to offer to help it restore democracy. This month he hosted a summit of big Muslim countries, and shortly he will be off to Seoul and Pyongyang, where he will doubtless endeavour to reunite the Korean peninsula after six decades of division.

So far, Mr Yudhoyono has little to show for this burst of diplomacy. His most notable foreign-policy achievements of late have been a spat with Australia over refugees, and another with China, after he let Taiwan's president, Chen Shui-bian, make a brief visit this month.

Although Turkey, Egypt and other Muslim countries recognise Israel, Indonesia does not. This greatly reduces its chances of being useful in resolving the Israeli-Palestinian conflict. Though Indonesia gets on well with both Iran and America, and thus in theory could help bring them together, there was nothing but the usual sabre-rattling from Iran's president, Mahmoud Ahmadinejad, when he visited Jakarta last week. Mr Yudhoyono's summit of Muslim leaders, held shortly afterwards, did not even discuss the issue. Myanmar's generals, far from democratising, have cracked down even harder on their opponents since the Indonesian leader's visit.

Mr Yudhoyono's diplomatic initiatives are unlikely to win him many plaudits back home. He hopes his recent Arabian tour will bring in billions of petro-dollars in investment and thus much-needed jobs. However, potential investors would probably have preferred that he stay at home and reform Indonesia's dysfunctional courts and restrictive labour laws.

Besides winning Indonesia a seat on the United Nations' new human-rights body, Mr Yudhoyono's main foreign-policy achievement so far has been improved relations with the United States. Last year, encouraged by Indonesia's deepening democratisation and its co-operation in fighting terrorism, America scrapped its restrictions on military aid (including providing weapons) to the country. But if he cuddles up too closely to George Bush, Mr Yudhoyono risks the fate of Pakistan's Pervez Musharraf, scorned by many fellow countrymen as America's lapdog.

Still, there are potentially some benefits. Indonesia is the world's most populous Islamic country and Mr Yudhoyono its first directly elected leader. A larger global role for it and for him could set a fine example to the rest of the Muslim world. But real world leaders have to be prepared to stick their necks out occasionally—something which does not come naturally to Indonesia or its cautious president.

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Afghanistan

Dial M for mujahideen

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From The Economist print edition

The country goes phone-crazy

JUST as the first meagre signs of normal life have begun to return to Afghanistan, the country erupted into some of the heaviest fighting since the American-led invasion in 2001. Some 60 people were killed as Taliban fighters battled with police and soldiers in Helmand province where thousands of British troops are now deployed. Meanwhile, the first street signs have begun to appear in the capital—a first small step towards the establishment of a functional communications network. But it is in telecommunications that Afghanistan has advanced most.

When the Taliban fell, there were just 20,000 telephone lines in the country and no means to phone abroad. Today there are 1.3m mobile phone users taking advantage of mobile coverage that stretches to many rural areas. Last month, delegates from across Afghanistan gathered in Kabul for a conference on information and communications technology to discuss, among other developments, the construction of a new optical-fibre voice-and-data network which will follow the ring road that girdles the country and finally connect it to the outside world.

The advance in technology will be enormous, just how enormous being demonstrated by the fact that the invitations to the conference were sent on an ancient Morse telegraph system. It is currently the only fixed-line connection between Kabul and all 34 provincial administrations. When binary code replaces Morse, the old telegraph will at last become history.

The arrival of mobile phones has had a far-reaching impact, not only on business, but also on the country's social fabric. In Kabul, mobiles have revolutionised the previously minutely controlled contact between the sexes. Even the Taliban have embraced the technology; they have at least two press spokesmen and they have also put their mobiles to less constructive use as the detonators for roadside bombs.

The Ministry of Communications is privatising the state's telecommunications assets and has created Afghan Telecom, which may now start to reduce the high cost of calls (around 15 cents a minute) offered by the still partly state-owned Afghan Wireless and Roshan, which is owned by the Aga Khan. Two other mobile players are due to enter the market in the coming year, having paid $41m each for their licenses: a big sum in Afghanistan.

But how big is the market? Mobiles are a lifestyle accessory aspired to by many Afghans and they can bring huge economic benefits to town and country alike. But the absence of reliable power supplies in all but a couple of cities will probably limit the take-up.

And while the government sings the praises of information technology, its potential can be realised only if there is the software and expertise in place in the provinces to take advantage of it. Young Kabulis are already surfing the internet and signing up for online degree courses at Indian and Pakistani universities. But the flow of Western pornography and popular culture from the web is alarming the conservative-dominated Information and Culture Committee in the new parliament. The parliament recently refused to ratify the appointment of the information minister and wants his replacement to be more of a traditionalist. That might spell an early end to Afghanistan's techno-dreams.

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Pakistan

Ganging up

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Two exiled former prime ministers plot their return

THEIR enemy's enemy will never be a friend. But Benazir Bhutto and Nawaz Sharif have decided, for now at least, to bury the hatchet somewhere other than in each other's reputation. At a meeting in London on May 14th, the two exiled former prime ministers agreed to a “charter of democracy” and decided to join hands in opposing the rule of Pervez Musharraf, Pakistan's president and army chief.

The charter is designed to restore civilian rule and ensure that the army, which has regularly intervened in Pakistani politics ever since the nation's foundation in 1947, goes back to the barracks and stays there. It would reduce the powers of the president in favour of the prime minister. The two party leaders announced that they would return to Pakistan before parliamentary elections due next year. General Musharraf has made clear that they are not welcome. On May 16th, he thundered that “rejected” and “corrupt” politicians had no future in Pakistan.

At the very least, their return will present General Musharraf with a public-relations difficulty. He might deport Mr Sharif, whom he deposed in a bloodless coup in 1999 and exiled to Saudi Arabia in 2000. Miss Bhutto risks arrest in Pakistan on corruption charges. But the general professes faith in democracy, which may make it awkward to lock out or lock up the leaders of Pakistan's two biggest mainstream parties just before an election.

The commitment to democracy, however, has its limits. General Musharraf is already engaged in manoeuvres aimed at extending his rule beyond his five-year presidential term that expires next year. He may be intending to retain his army uniform as well. In the previous elections, in 2002, the army arranged a vote that produced a manageable National Assembly, and would hope to do so again. Miss Bhutto's People's Party and Mr Sharif's wing of the Muslim League say they will contest the elections only under a neutral caretaker government. Mr Sharif wanted the People's Party to announce a joint struggle and electoral alliance. Miss Bhutto refused, prompting accusations that she was in secret touch with the army. A charter of democracy perhaps, but not of trust.

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Sri Lanka

Broken pieces

May 18th 2006 | DELHI
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A 23-year-old war turns bloody again

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MORE than 200 people, mostly civilians, have been killed in the past month alone in Sri Lanka's rekindled civil war, and more than 20,000 have been displaced from their homes. A ceasefire agreement, signed in 2002, is still notionally in force between the government and the Liberation Tigers of Tamil Eelam, who have been fighting for a homeland for the Tamil minority in the north and east of the island. But respective spokesmen for the Tigers and for the Swedish general leading a group of Nordic ceasefire monitors have used the same phrase to describe its current status: “low-intensity war”.

Even that is beginning to sound like a euphemism. On May 13th, on Kayts, a tiny island off the north-western coast, 13 Tamils, including a baby and a child, were shot dead by unknown gunmen. The government has condemned the slaughter. But the Tigers have accused its navy of responsibility. Two days earlier, the Tigers had attacked a naval convoy escorting a ferry with more than 700 soldiers on board, killing at least 17 sailors, and losing perhaps 50 “Sea Tigers”.

That blatant violation of the ceasefire has forced the monitors to suspend their work at sea. No government recognises the Tigers' claim to sovereignty over waters off the territory they control. But it is part of their attempt to achieve symbolic equality with the government should peace talks, stalled since February, ever resume. They also rely on the sea to smuggle in weapons and other supplies, and to transport fighters to and from their areas in the north and in the east, which are in places separated by government-controlled territory.

This constraint is complicating the Tigers' struggle with a splinter group in the east, led by a commander known simply as Karuna, who split from the northern leadership two years ago. The Tigers insist—plausibly—that the army is helping Karuna and that it must disarm his faction before peace talks can resume.

This is the Tigers' pretext for stepping up their attacks, which included an attempt last month to kill the Sri Lankan army commander in a suicide bombing in the capital, Colombo. The army retaliated with air raids on Tiger positions, in which civilians also suffered. Earlier in April, government soldiers had tolerated mob violence against Tamils by members of the Sinhalese majority in the eastern town of Trincomalee. All of this tends to make even Tamils who do not support the Tigers turn to them for protection.

Both sides are trying to strengthen their position on the ground before they start talking peace again. The risk, however, is that the tit-for-tat exchanges will gather unstoppable momentum and that a low-intensity war will end not in peace talks but in a high-intensity one.

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Israel

Who's a citizen?

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A decision by Israel's Supreme Court has reignited the Jewish state's debate about how it should keep itself Jewish

Get article background

WHICH basic human rights may a country override to keep itself safe? And to keep its demographic status quo? Such questions have been tormenting America and Europe recently. This week they reared their head, not for the first time, in Israel.

By six votes to five, the Supreme Court rejected petitions from two human-rights groups asking it to overturn the "Citizenship and Entry into Israel" law. Passed in 2003 as a temporary, emergency measure after Israel had suffered its worst-ever spate of suicide bombings, the law specifically bans residents of the West Bank and Gaza who marry Israelis from getting Israeli citizenship, residency or even entry permits. An amendment last year let Palestinians above a certain age apply for visiting permits, but left the security services with sweeping powers of refusal. Even in apartheid South Africa, says Adalah, a legal-advocacy centre that was one of the petitioners, a court once overturned a similar law as unconstitutional.

The law mostly affects Palestinian Israelis living in the towns bordering the West Bank, who have often married Palestinians from across the Green Line that marked Israel's border until the war of 1967. Yoav Loeff of the Association for Civil Rights in Israel, the other petitioner, says nobody knows how many couples the law keeps apart. Nor are there reliable statistics on how many Palestinians requested or got citizenship before the law was passed. "It was a policy made on the basis of a total lack of data", he explains. But judging from the calls to the association, the law has affected at least hundreds of families, if not thousands. Meanwhile, just 26 Palestinians who immigrated through marriage have been questioned on suspicion of aiding terrorists, though none has been convicted. Yet the state argued that this justified a broad ban. That is what divided the judges.

However, the ruling is less clear-cut than it seems. In Israel a law can be overturned if it violates the Basic Laws, Israel's underpowered version of a constitution, and is also "disproportionate": ie, if the harm it does to some outweighs the benefits to others. Nine of the 11 judges found the citizenship law unconstitutional and six deemed it disproportionate—a moral victory, in other words, for the activists. But only five thought the remedy was to throw out the law. The others decided, since the law is up for renewal soon anyway, to let parliament pass a better one.

The strong vote against the law's constitutionality means that parliament may well do just that. For besides keeping out terrorists in the short term, the Jewish state wants to keep itself Jewish in the long term. Immigrating to Israel has always depended on who you are: Jews get automatic citizenship, while non-Jews, like immigrants anywhere else, have to meet certain criteria. But in recent years *aliyah* (Jewish immigration) has slowed; non-Jews

are a growing slice of the population—especially Arab Israelis, who make up nearly a fifth of Israel's 7m citizens and have a higher-than-average birthrate.

Some politicians now want an immigration policy to counter that trend. Haim Ramon, the justice minister, said this week that he will replace the citizenship law with one “that will apply to everyone”. A government-appointed commission issued a draft set of proposals in February.

Its chairman, Amnon Rubinstein, who also backed the citizenship law, cites lots of international precedents for banning citizens of an enemy country in wartime. With Hamas, which now runs the Palestinian Authority, refusing to recognise Israel, many Jewish Israelis would apply that label to Palestinians. Less aggressive options would be to limit citizenship using economic criteria, age or other requirements that are colour-blind in theory but could be designed in practice to discriminate against Palestinians and any other nationalities that Israel does not want.

Critics of Israel argue that its obsession with its ethnic balance is more appropriate to the 19th century, when European ethnic-nationalist movements first inspired the idea of a Jewish nation-state, than to the modern world. Supporters retort that other countries where the ethnic majority is in peril are doing much the same thing. In Denmark, for instance, after high immigration and poor integration prompted 12% of Danes to vote for an anti-immigrant party in 2001, the government put curbs on immigration through marriage, including minimum ages and longer waiting periods for citizenship, and restricted welfare benefits for the first seven years. Israel's policy could end up looking similar—and very hard to assail in court.

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Hamas and the Arabs

Foul-weather friends or foes?

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No real help yet for Hamas from neighbouring Arab governments

Get article background

THREE years ago, the Arab League's 22 members agreed that they would all recognise Israel and declare peace, so long as the Jewish state withdrew from all the land it occupied in 1967. But Hamas, which now controls the Palestinian Authority, was elected on a platform that, at least notionally, rejects such a compromise. And Israel's government is looking at a policy that means withdrawing to borders to be decided by Israel alone, not to the pre-1967 lines. These two awkward new factors leave surrounding states in a pickle.

Most ordinary Arabs outside Palestine admire Hamas's defiant posture. Amid a region-wide religious revival, they tend to respect its Islamist credentials. Many saw in the electoral humiliation of its secular rival, Fatah, a useful warning to their own leaders, many of them equally venal and monopolistic. Capitalising on such feelings, Hamas leaders have toured the region to drum up support, arguing that Israel's unilateral policies have undercut Arab peace offers. They have been cheered by a stream of editorial comment berating the West as hypocritical for demanding democratisation, then balking at its results.

But in the region's chanceries, feelings for Hamas range from distaste to hostility. Countries such as Egypt and Jordan want calm on their borders, and fear anything that might encourage their own powerful Islamist oppositions. Not many years ago, Jordan expelled four of Hamas's top leaders. More recently, its police busted a gang of alleged Hamas gun-runners and cancelled a visit to Jordan's capital, Amman, by Hamas's foreign minister, Mahmoud Zahar. Egyptian officials have received Hamas emissaries, but privately endorse the view that Hamas should be cold-shouldered until it recognises Israel and commits itself to respect previous agreements.

The rich monarchs of the Gulf feel less threatened by Hamas. Yet they too are tired of rejectionism. Saudi Arabia has been a generous patron to the Palestinians in the past and its rulers incline towards Islamist causes. But the al-Sauds prefer their own reactionary Wahhabist brand of Islam to Hamas's more modern republican approach. Nor do they like Hamas's closeness to Iran, the rival claimant to leadership of the Muslim world. “Of course there is a human side to the funding issue,” says a government minister in the Gulf. “But at the same time there has been an Arab consensus on a peaceful solution, and we would like Hamas to sign onto this.”

Even Syria, which has long been host to Hamas's exiled leaders, and loudly backs the notion of perpetual resistance to Israel, has a chequered relationship with the group. An Islamist electoral victory may be fine for Palestine but, in Syria, mere membership of the Muslim Brotherhood, of which Hamas is a branch, remains a capital crime. The exiled leader of Syria's branch of the Brotherhood recently joined other members of the Syrian opposition to announce a front aimed at toppling President Bashar Assad's regime.

In any case, what Palestinians need most just now is not rhetoric, but money. The issue of funding is where the ambivalence of Arab regimes shows most clearly. The West's denial of finance to the Hamas-led government, and America's intervention to block bank transfers, are commonly decried as forms of blackmail. While Palestinians' misery increases, Islamist groups have campaigned for private donations. Such calls, and a $50m pledge by non-Arab Iran, have shamed some governments into coughing up: Qatar has promised $50m, Saudi Arabia a reported $90m, and the Arab Monetary Fund some $50m.

But at the last Arab summit meeting in March, governments agreed only to maintain their previous level of funding. And even so, attempts by the Arab League to find some way to transfer cash by circumventing banks, which fear retribution under America's long-reaching anti-terrorism laws, have so far come to nought. Hamas officials say that $350m of Arab money has accumulated in this way.

At a recent meeting in New York of the Quartet group (comprising the UN, the European Union, the United States and Russia) that is meant to broker Palestinian-Israeli peace, diplomats from Jordan, Egypt and Saudi Arabia did argue strongly in favour of loosening the aid blockade. Yet, for the time being, Arab rulers may feel obliged to go along with the American administration's apparent policy of squeezing Hamas into submission.

But as distress in the West Bank and Gaza mounts, neighbouring governments are starting to feel that, whatever

they think of Hamas, some way must be found to break the siege, if only to quell rising public outrage in their own countries.

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Libya and the United States

Another big hug

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Why America is befriending the Libyan leader it long reviled

"THE United States is a damned country that deserves only to be cursed. It declares its own occupation of our lands legitimate, but brands our resistance as terrorists." This was not the Libyan leader, Muammar Qaddafi, speaking 20 years ago, when his country was a pariah and he was the butt of international scorn. The words were spoken only last month, by the Libyan parliament's deputy speaker, Ahmed Ibrahim, at a gathering in Tripoli, Libya's capital, to commemorate its bombing by American aircraft in 1986.

Mr Ibrahim's stridency was, perhaps, inspired by America's decision, in March, to keep Libya on its official list of state sponsors of terrorism, a dubious distinction it has held since 1979. All the more striking, then, that the American administration should have decided, this week, to restore full diplomatic relations.

AFP

George Bush's new buddy

In fact, the two countries have been edging closer for years—for reasons of pure realpolitik. Mr Qaddafi's regime is certainly less bad than it was. It has not terrorised anyone outside its own borders for a long time. It has opened its economy a crack to foreign investors, invited tourism and slightly lifted oppressive controls on its own citizens. But none of those things matters as much to America as big oil, alliances in the fight against Islamist extremism and the scoring of points in the current stand-off over Iran's nuclear ambitions.

Libya has the largest oil reserves in Africa, safely distant from the Persian Gulf, and has historically cosy relations with American oil firms. More crucial to the Bush administration has been Libya's importance in countering al-Qaeda and its offshoots. Mr Qaddafi's intelligence services, once feared as global troublemakers, are among the most ruthless in the region. Ever since Libya's leader was himself targeted for assassination by Muslim radicals (at least twice in the 1990s), he has been one of their keenest foes.

Seizing the opportunity of the attacks on America in 2001, Libyan intelligence has co-operated fulsomely with sister agencies. It has helped interrogate prisoners at Guantánamo and joined in an American-sponsored plan to track and contain Islamist guerrillas across the Sahara. Among other rewards, it has secured the "rendition" of Libyan Islamists nabbed by the Americans as far afield as Afghanistan, Thailand and Hong Kong.

Equally significant was Mr Qaddafi's decision, in 2003, to let British and American experts take apart his secret weapons programme, bringing a windfall of information about global smuggling networks. The Americans parade this change of heart as a model for countries such as Iran and North Korea.

Still, why the rush to exchange ambassadors? One reason may be a rising feeling in Tripoli that being nice to America has brought little reward. Rumblings of dissent, such as Mr Ibrahim's speech, may have prompted the Americans to make a gesture to prevent Mr Qaddafi from again slipping out of the fold. This week President Bush sent Congress a report on Libya which should lead to its removal from the list of state sponsors of terrorism.

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Nigeria

A president frustrated

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Nigerians reject their head of state

AFP

You can't throw that hat in the ring

MONTHS of speculation that President Olusegun Obasanjo might get the constitution changed to let himself run again for a third term of office ended abruptly this week when a proposed amendment was rejected by the Senate. Mr Obasanjo accepted the verdict in a speech to the National Assembly on May 18th. His jubilant opponents hailed the vote as a victory for Nigeria's fragile democracy. National elections due next year should now mark the first time that a civilian president of Nigeria hands over to another.

Mr Obasanjo's supporters said that they wanted him to stay in power to complete his economic reforms. But the real impetus to keep him came from venal state governors who want another four years in power and tycoons who rely on their presidential connections.

Some thought that the wily Mr Obasanjo, a former military ruler in the 1970s, might have made another attempt to amend the constitution, but it is hard to see how he would have done this. He needed a two-thirds majority just to reintroduce a further constitutional review in the Senate, then another two-thirds majority of Nigeria's 36 states to vote in favour of any amendment.

In any case, Mr Obasanjo's popularity across the country has plummeted. He has failed to bring the benefits of Nigeria's oil riches to ordinary people and faces an open revolt in the oil-producing region of the Niger delta. His ambition for a third term had also alienated his once-loyal Western backers. Even the American government had publicly urged him not to stand again.

In desperation, he could still take advantage of civil unrest, especially in the delta, to declare a state of emergency and delay the elections. But that is now unlikely. Indeed, Mr Obasanjo's ruling party is already casting around for new candidates.

Finding one will not be easy in a country of 130m people split evenly between Christians and Muslims and divided by three main ethnic groups. With no obvious hand-picked successor, candidates from the Muslim north are lining up to succeed Mr Obasanjo, a Christian southerner. Two front-runners are Ibrahim Babangida, a former military ruler, who annulled elections in 1993, and Atiku Abubakar, Mr Obasanjo's estranged deputy, who was quick to laud the Senate vote.

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The Pan-African Parliament

Going for broke

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A continental parliament is struggling to make ends meet

THE infant Pan-African Parliament, known as the PAP, is having serious growing pains. Two years after its inauguration, it is facing the kind of problem familiar to the United Nations: stingy members. As with the UN, the culprits are among the richest members. For a body supposed to foster closer unity on the continent, its start has been inauspicious.

Set up under the aegis of the African Union (AU), the PAP is supposed to develop, eventually, from an advisory body into a fully-fledged legislative one. It already has a swanky building just north of Johannesburg, but not, it seems, the money to do much inside it. The PAP was counting on getting $24m this year, half from the 53-member AU, the rest from member countries paying expenses related to their MPs. But many countries have failed to fund their representatives, and so far the AU has coughed up only $5.9m of its $12m share. When the chairman of the PAP's finance committee went to the AU hat in hand, he was told that there was no money. South Africa, Libya, Nigeria, Algeria and Egypt between them are expected to contribute 75% of the AU's whack this year. So far, only South Africa has paid up in full.

The bad guys are hardly the continent's worst off. Oil-rich Libya is known for its largesse towards other African countries but may be bitter over losing its campaign to host the new parliament. With oil prices running high, Nigeria should not be short of cash either. But it may have other, more pressing, priorities: the government has just approved a master plan to send a Nigerian to the moon by 2030, after launching a $90m space programme in 2001.

None of this is helping the young parliament reach legislative adulthood. It is even struggling to be taken seriously by its own sponsor. Although it sent a fact-finding mission to Darfur last year and tabled recommendations, it was left in the dark when the AU helped rebels and the Sudanese government to negotiate a peace deal, signed in Nigeria earlier this month.

The cash-strapped parliament is hoping that an appeal to African heads of state, due to meet in July in Gambia, will bear fruit. Otherwise, it may join the queue knocking on the doors of rich non-African countries.

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French politics

Beyond saving?

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The end approaches, for an undistinguished government and president alike

Get article background

A DECADE or so in power saps the authority of any political leader. Just ask Britain's Tony Blair. But the troubles afflicting France's president, Jacques Chirac, in the twilight of his 11-year-old presidency, are chronic. His government this week survived a vote of no confidence, but emerged no stronger. Most debilitating of all, its credibility is being undermined mainly by an internal war of attrition.

With an absolute majority in parliament, the ruling centre-right UMP party comfortably saw off the censure motion, proposed by the Socialist Party. Ahead of the vote, Dominique de Villepin, the prime minister, spoke defiantly of his plans to create a “fairer, more united and more confident” society. But his fighting talk scarcely registered. More than half the UMP's deputies did not vote. François Bayrou, leader of the centrist UDF party, which has a minister in the government, voted against it for the first time since the party was created in 1978 by then President Valéry Giscard d'Estaing. “Our country,” declared the Socialist Party, “is going through one of the most serious political crises of the fifth republic.”

The immediate cause is the “Clearstream affair”, named after a Luxembourg clearing house. A baffling web of judicial and intelligence inquiries, it now centres on a list compiled by a *corbeau* (crow), or anonymous informer, that sought to link certain politicians, including Nicolas Sarkozy, the UMP leader and current interior minister, to offshore bank accounts. The list turned out to be phoney. As suspicions of an orchestrated smear campaign grew, an inquiry was launched to uncover the *corbeau*. During this inquiry, many leaks of testimony have emerged, particularly in *Le Monde*, a left-leaning newspaper.

Until the judges place suspects under formal investigation, let alone conclude their work, there will be as many questions as answers. Mr de Villepin, Mr Sarkozy's chief rival on the right, has not denied that, as foreign minister, he ordered a covert inquiry into the allegations by General Philippe Rondot, a top spy then working for the defence ministry. He did this at a meeting in January 2004 with Jean-Louis Gergorin, an executive at EADS, a defence firm, who knew Mr de Villepin from a previous stint as a diplomat. “My feeling,” General Rondot said last weekend, “is that Jean-Louis Gergorin is at the origin of the affair.” Mr Gergorin, who denies being the *corbeau*, was last week “relieved of his duties...in order to prepare his defence”. This week, another EADS executive, Imad Lahoud, who also denies being the informant, took leave for the same purpose.

The past two weeks have seen a war of words. Mr Sarkozy's camp suspect what one calls “an attempted political murder”. Mr de Villepin at first denied that Mr Sarkozy's name was mentioned at the meeting, then confessed that it was, but only in his then capacity as interior minister. Mr Chirac has denied that he told Mr de Villepin to set up the inquiry, as General Rondot has testified. The general now denies that Mr de Villepin ever asked him to

investigate Mr Sarkozy. Yet his meticulously kept notes, seized by the judges, report Mr de Villepin's “fixation” with Mr Sarkozy. In his leaked testimony, General Rondot also said: “I acknowledge having lied [in a memo to the defence minister]...in order to shelter and protect my minister and myself from the accusation of having participated in a dubious operation to the detriment of Mr Sarkozy.” The general says he will no longer co-operate with the judges, because of all the leaks.

The upshot of this extraordinary tangle is paralysis in government, and disgust on the street. Mr de Villepin this week counter-attacked, arguing that due judicial procedure was not being respected, and deploring what he called “slander, lies and rumour”. “I refuse these dirty practices, which discredit politics,” he said. Yet the affair has quite clearly distracted ministers from their jobs. “This is not a government,” said François Hollande, the Socialist leader. “It's a battlefield.”

Even before this latest saga, Mr de Villepin had lost most of his authority after he backed down, on presidential instructions, in the face of mass protests against a new labour-market contract. Only six months ago, he had to introduce a state of emergency after riots in the suburbs. For the time being, Mr Chirac declares confidence in his enfeebled prime minister. But pressure is building among restless UMP deputies, fearful for their jobs after the election next year. Mr Chirac dislikes reacting in the middle of a storm. Yet when the country is distracted by the soccer World Cup this summer, a switch of prime ministers cannot be ruled out.

Who would it be? The obvious choice is Mr Sarkozy, whose popularity has not collapsed with the government's. A hyper-energetic fighter with an iron streak, he might bring order to Mr Chirac's last year. Yet he would not accept the job without being given a free rein to put in place the “rupture” with today's policies that he has long been preaching. Many within his camp want him to quit now, to break the association with Mr Chirac, though Mr Sarkozy has said that he will stay for the time being. For his part, Mr Chirac, who had been grooming Mr de Villepin as a presidential hopeful and has long distrusted Mr Sarkozy, would be loth to grant him the liberty he seeks. Instead, if he makes a change at all, Mr Chirac may turn to a lesser-known, more biddable caretaker.

The electorate veers between indifference and repulsion. Talk to ordinary voters far from the Paris elite, and the overwhelming reaction is nausea. A *Paris-Match* poll last week suggested that the Clearstream affair ranked only tenth among subjects of conversation; top was petrol prices. “For the electorate, the affair confirms the view that the political class is a separate caste that does not apply to itself the rules it applies to others,” comments Dominique Reynié, a political scientist at the Institut d'Etudes Politiques.

Up to a point, the Socialists stand to benefit from this disillusion. Ségolène Royal, the darling of the polls, now enjoys a popularity rating of 68%, according to Ifop, a pollster, compared with 57% for Mr Sarkozy and only 39% for Mr de Villepin. Despite the scorn poured on her by Socialist old-timers, she has so far resisted efforts to dismiss her potential candidacy as a media illusion. The party will choose its presidential candidate in November.

There is one other potential beneficiary: the far-right National Front. Its leader, Jean-Marie le Pen, has long played on disaffection with the elite as much as on xenophobic nationalism. Over the past month, according to a TNS-Sofrès poll, his popularity has jumped by four points to 18%—his best rating since 1996.

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Europe and Islam

Heading for the land of the free

May 18th 2006 | AMSTERDAM
From The Economist print edition

A noted critic of Islam leaves the Netherlands

SOME Americans believe that Europeans have lost the desire to defend their values against extremists (especially those of the ultra-Muslim variety). The news from the Netherlands this week appears, at first sight, to confirm their fears.

The European career of one of fundamentalist Islam's best-known critics, a member of the Dutch parliament who was born in Somalia, ended on May 16th with a dramatic but dignified public statement. Faced with the cancellation of her Dutch citizenship because of untruths she told when she sought asylum in 1992, Ayaan Hirsi Ali announced that she would head for the more congenial atmosphere of America. Dutch politics will not be the same without her: she has been a charismatic standard-bearer of the political right. She has also lived with continual death threats ever since her close friend, Theo van Gogh, was murdered in 2004 after making a film (for which she wrote the script) that used graphic images to denounce Islam's attitude to women.

AP

Hirsi Ali bids a tearful farewell

Her farewell to the Netherlands was delivered with a well-judged mix of emotion and political skill. She said she had entered Dutch politics in 2003 because she wanted to highlight the oppression of immigrant women not just by their host country, but by their own religion and culture. She "wanted politicians to grasp the fact that major aspects of Islamic doctrine and tradition, as practised today, are incompatible with an open society." Summing up her work, she said she had contributed to a transformation of the Dutch debate on culture and faith, a claim nobody would deny. As she prepares to take up a post with the American Enterprise Institute, a conservative think-tank, admirers may feel that, for a second time, she is getting asylum from a hostile society.

Yet seen from close up, it is not quite that simple. She was not forced to leave the Netherlands because she had criticised Islam and its treatment of women. What triggered her move—or hastened one that was already planned—was a television documentary that highlighted some awkward facts about her past which were already mostly in the public domain, and had certainly not been denied by her. On arrival in the Netherlands, she lied about her age and name, and gave (as she puts it) a partially fabricated story to boost her asylum claim. But she still insists that she came under duress—fleeing an arranged marriage to a cousin from Canada who made a deal with her father.

In any case, the scandal over the circumstances of her arrival prompted Rita Verdonk, the immigration minister—a fellow member of her centre-right party—to tell her starkly that she must consider herself "not to have received Dutch nationality". That may not be the same as an instant expulsion order, but it led to Ms Hirsi Ali's abrupt resignation from parliament. Less than 24 hours after the most famous Dutch immigrant had announced her emigration, parliamentarians of all stripes held an all-night sitting to urge the minister to back off, but it was too late.

In truth, life had been getting harder for Ms Hirsi Ali for some time. Last month, a court ordered her to leave her apartment, at the behest of neighbours who feared for their own safety. Without parliamentary immunity or security guards paid for by the state, her life in the Netherlands could have become very dangerous indeed.

Lying behind Ms Verdonk's decision are two changes in the Dutch mood since fears over the compatibility of Islam and liberal democracy reached a peak in 2004. On the one hand, voters appear to like the strict, zero-tolerance migration controls which the minister, a candidate for her party's leadership, has pioneered. On the other hand, more now accept the need for "multiculturalism" of the kind Ms Hirsi Ali abhors as a price for social peace.

Would it be right to conclude, therefore, that Europeans are incorrigible appeasers of fundamentalist Islam? Jonathan Laurence, a professor at Boston College, argues that America may be an easier place than Europe to be either a Muslim or an anti-Muslim. The State Department has scolded France, on civil-liberties grounds, for keeping

Muslim headscarves out of schools. When the European Court of Human Rights upheld Turkey's (even stricter) curbs on the headscarf, that was a disappointment for American libertarians. So Europe can be tough; what it lacks is a robust culture of free speech and free personal behaviour.

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Italy's new government

Prodi's team

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A left-leaning government that may not last long

AS HE unveiled his government on May 17th, Italy's new prime minister, Romano Prodi, noted that it was “the same day [of] the same month” as ten years earlier, when he had named his first cabinet. There the similarities end.

His government may be the most left-leaning that Italy has ever had. Of its 26 members, one belongs to the Green party, which in Italy stands well to the left; two are communists; and nine (including the foreign minister, Massimo D'Alema) are Democrats of the Left, heirs to the former Italian Communist Party. As expected, the finance ministry will go to a distinguished independent, Tommaso Padoa-Schioppa. But the other main economic portfolios—industry, employment and transport—are all going to communists or ex-communists. That scarcely augurs well for the radical (ie, liberal) reforms that Mr Prodi's centre-left alliance had promised.

The prime minister, a mildly progressive former Christian Democrat, may have wanted a different outcome. But the communists and Greens made impressive gains in last month's election. Mr Prodi, who has a one-seat majority in the upper house of parliament, the Senate, is in no position to resist demands from smaller parties in his coalition.

In the tough bargaining that went into forming his government, at least two hopes were cast aside. Mr Prodi had wanted fewer ministers than his predecessor, Silvio Berlusconi. He ended up with two more (and five more than in 1996). He also vowed that a third of his team would be women. In fact, less than a quarter will be; and five of the six women in the team will be without a cabinet portfolio.

One of these second-class ministers is a spirited former European commissioner, Emma Bonino, who will be Europe minister. She had wanted the defence ministry. Her failure to get it shows the problems created for Mr Prodi by his narrow victory—and suggests that his government may not last all that long.

Some on the far left opposed Ms Bonino's appointment as defence minister on the grounds that she is not against war. But the real reason she was blocked is that another, newly powerful figure wanted the job. Clemente Mastella, a former Christian Democrat, leads a party on the right fringe of the governing coalition that took less than 1.5% of the vote. But it has three vital seats in the Senate. And in the past it has signalled that it is ready to desert the centre-left if its demands are not met.

To break the deadlock, Mr Prodi gave defence to a close associate, Arturo Parisi. But to pacify the troublesome Mr Mastella, he handed him the even more prestigious justice ministry. Mr Mastella expressed delighted surprise. As well he might: for he is utterly unsuitable. More than once, he has chided prosecutors for their impertinent curiosity about political corruption. Only three months ago he was questioned at the headquarters of the national anti-Mafia directorate about his friendship with a man who admitted to helping the Sicilian Cosa Nostra's former “boss of bosses”, Bernardo Provenzano, when he was on the run.

Francesco Campanella, a town councillor in Sicily who turned state's evidence after being investigated, has acknowledged giving Mr Provenzano documents that helped him to go abroad for medical treatment. A year earlier, Mr Mastella was a witness at Mr Campanella's wedding.

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Italian sport

Football fiasco

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Match-fixing, Italian-style

Reuters

SILVIO BERLUSCONI says it was a rigged contest that his side won. Not Italy's election: its football championship. His team, AC Milan, finished second in both the past two seasons to Juventus. But the Turin team is at the centre of a match-fixing scandal that may be the biggest even this country has seen. On May 16th, less than a month before the start of the soccer World Cup in Germany, Italy's top sporting body, the Olympic committee, put the national football federation under emergency rule. The federation's president had quit after claims that he ignored evidence of misconduct by officials, referees and players. The committee chose a 75-year-old former stockmarket regulator, Guido Rossi, in his place.

The evidence in the case comes from prosecutors in Naples who are looking into 19 games that were played in Italy's top division in the 2004-05 season. Seven matches involved Juventus, whose board has now resigned. Shares in the publicly traded club have plunged as investors fret that Juventus could be stripped of its titles, and even demoted. *Il Sole-24 Ore*, a financial daily, reckons that would cost the club as much as €120m ($160m) in lost sponsorship and television revenues.

Juventus's general manager, Luciano Moggi, also resigned on May 14th. Leaked extracts from intercepted telephone conversations suggest that he habitually secured amenable referees for his team, rewarding those who favoured it, and punishing those who did not. They record him boasting of locking match officials in the changing room as a reprisal, and urging a television journalist to tamper with a slow-motion replay to hide a wrong decision in Juventus's favour. His reputation for fixing matches was such that the interior minister in Mr Berlusconi's government once rang him to ask for help for his local side, playing in a lower division. Some weeks later, the transcripts show Mr Moggi taking a grateful call from the club's chairman.

Football fans have long suspected that Juventus, which for years was universally associated with the Fiat automotive group and a symbol of Italian industrial pride, gets unduly favourable treatment. But investigations in Naples and three other cities point to corrupt practices far beyond Turin. Several teams are involved. One of them is AC Milan.

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Germany's Social Democrats

Beck's battle

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A new leader takes over a troubled political party

"THEN come, comrades, rally—and the last fight let us face." These words from the *Internationale* have seldom been more suited to Germany's Social Democrats (SPD). Last weekend the party chose Kurt Beck, premier of Rhineland-Palatinate, as its new chairman. He was the only plausible candidate after his predecessor, Matthias Platzeck, had resigned earlier in the year on health grounds. The task facing Mr Beck is immense: the SPD risks losing its status as a "people's party".

One might expect the party to be in better shape. It managed almost to pull even with the Christian Democrats (CDU) in last year's federal election, and it is now ruling in a "grand coalition" with the CDU. In state elections in March it did quite well. Yet the SPD is in its "worst post-war crisis", says Manfred Güllner of Forsa, a polling firm. Indeed, the party increasingly looks like a head without a body: only five states still have an SPD premier, and many of its erstwhile bastions in the big cities are now controlled by the CDU.

It will be hard to turn this around. Germany's oldest party is like a church that is losing its faithful, lacks trained clergy and is groping for a new doctrine. Since 1990, membership has dropped by some 40%, to 580,000. There is little political talent waiting in the wings. And the party has yet to come up with a programme that responds convincingly to changes in the world since German unification.

Nor has it done the SPD much good to be part of the ruling coalition. The government's popularity is ebbing in any case, but what it has sticks mostly to the CDU and its chancellor, Angela Merkel—not least because she sometimes sounds like a Social Democrat herself. It is awkward for the SPD to differentiate itself without endangering the coalition. In recent opinion polls, the SPD has sunk to 30% nationally, a full ten points behind the CDU.

Mr Beck may yet revive a party that is still suffering in the wake of Gerhard Schröder, the former SPD chancellor. Mr Schröder distanced himself from his party and pushed ahead with some economic reforms heedless of its loss of popularity. Mr Beck is not only deeply rooted in the party, but also a good reflection of what remains its core constituency: he rose from humble roots as a trained electrician. He promised during his speech at the congress to start a new membership drive and to listen again to the rank and file.

Although he is good with people, Mr Beck is less at ease with policies. His speech to the congress consisted mostly of standard SPD fare, leaving it to his short-lived predecessor, Mr Platzeck, to outline a vision for the future. Showing that he will be much missed, Mr Platzeck argued that the SPD should bid farewell to the traditional welfare state, which tried to achieve equality through transfer payments, and fight instead for one that "makes provisions" to avoid inequality in the first place, for instance by investing more in education and the integration of immigrants.

Even so, it would be wrong to underestimate Mr Beck. He has been re-elected three times in Rhineland-Palatinate, most recently with an absolute majority in parliament. His homely approach, cautious support for reform and will to get things done could appeal to voters. He would not be the first earthy, well-rounded leader from the state to prove Germany's highbrow press wrong: when Helmut Kohl became CDU leader in 1973, most pundits declared that he had only a limited future.

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Romania and Bulgaria

A dim green light

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A mumbled invitation to join the European Union in 2007

ROMANIANS have a joke about driving to Greece. Tank up before you get to the Bulgarian border, lock the doors and windows, put your foot down and don't stop until you reach the other frontier. Bulgarians say the same about driving north to Hungary. Other Europeans, it seems, would rather drive elsewhere.

Romania and Bulgaria are due to join the European Union on January 1st 2007. This week, the European Commission could have advised that they get the formal go-ahead. Instead it fudged. Preparations for admission should proceed, it says—but with a further review in the autumn of progress on reforms. If either country scores spectacularly badly then, its accession could be put off for a year.

In practice, any such delay now looks out of the question for Romania, and highly unlikely for Bulgaria. Romania was originally seen as the more problematic of the two. It is big, with 20m people, very poor, and was until recently ruled by a venal and incompetent clique of ex-communists and their hangers-on. But over the past two years Romania has made startling progress, particularly in the trickiest areas of judicial administration and home affairs. The commission says it is now worried only about minor issues, such as improving slaughterhouse hygiene.

Such quibbles spare a few blushes next door, where the criticism is sharper. Bulgaria has signally failed to match Romania's new law-abiding ways. Gangland killings are frequent, and go unpunished. The suspicion is that the authorities are too scared, or too weak, to tackle the perpetrators. Or too complacent: Klaus Jansen, a senior German law-enforcement official, complained recently of a “kiss my ass” attitude among his Bulgarian counterparts.

The next five months are unlikely to change matters much. It is still possible, just, that the treaty sealing Bulgaria's membership will not be ratified by one of the current members. More likely is that Bulgaria will still join with Romania, but will be hedged about with more conditions. The dollops of EU money that both countries need, to build new roads and improve their public services, could be held back if reforms falter.

The real worry is not the pretence of pressure on the two Balkan front-runners, but the dimming prospects for membership elsewhere in the region. The peace of recent years in the countries of former Yugoslavia is largely held together by the hope that it will bring the eventual boon of EU membership. Indeed, in disputed places such as Kosovo and Montenegro (which votes on independence this weekend), the idea of a nation-state operating outside a tight international club such as the EU could be catastrophic.

An international commission on the Balkans, composed of grandees, recently urged the EU to keep open the door, to “show that it has the power to transform weak states and divided societies.” If it does not, it will “remain mired as a reluctant colonial power at enormous cost”. Such instability is one worry if enlargement stalls. Another is that more countries, notably Ukraine, are waiting for their turn, after Turkey, which has already begun negotiating. There is a deafening lack of enthusiasm for any of them.

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Charlemagne

The Angela and José show

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But Helmut and Jacques, they're not

THEY are Europe's odd couple: she, the cautious anti-communist physicist, who wants the European constitution but says economic reform can be delayed; he, the animated former Maoist turned law professor, who bangs on about economic reform but says that the constitution should be postponed. Mismatched as they may seem, Angela Merkel, the German chancellor, and José Manuel Barroso, the European Commission's president, have struck up the most important political relationship in the European Union.

On successive days last week, the two gave speeches about the EU that could have been planned in concert, with an eye on the first half of next year when Germany takes over the presidency of the EU. Both called for more work on the constitution, albeit with differing degrees of urgency; less red tape; and more consumer protection. If anybody is directing the EU (admittedly, a big if), it is this pair from Germany and Portugal.

Their partnership has come about *faute de mieux*. True believers in European integration always whinge about "lack of leadership", but that lack is palpable right now. Only 26% of British voters approve of the job Tony Blair is doing as prime minister, making him the least loved Labour prime minister since the war. Barely a fifth of French voters approve of Jacques Chirac's performance as president. These levels of support would discourage any sane politician from reopening the contentious issue of the EU constitution in France or Britain. In Italy Romano Prodi has gone from narrow electoral victory to popular disenchantment without even the intervening stage of forming a government. The Polish coalition has brought in a virulently anti-European populist party to shore up its majority. The Dutch are still looking inwards. With Euroscepticism growing in almost every EU member, no leader besides Ms Merkel has the political capital to take risks for the sake of wider Europe.

But Ms Merkel and Mr Barroso have more in common than not being consumed by domestic concerns. Both are from the centre-right. Both are fervent Atlanticists. Both put the slightly awkward combination of improving ties with America and cutting red tape at the top of their agendas. During the contest for the presidency of the European Commission in 2004, Ms Merkel (then in opposition) quietly backed Mr Barroso. By winning the chancellorship, she liberated him from the legacy of his own selection. Mr Chirac and her predecessor, Gerhard Schröder, had promoted a Belgian candidate instead; both criticised Mr Barroso for being an Anglo-Saxon ultra-liberal. Ms Merkel has lifted the albatross of Franco-German hostility from his neck.

The two have been able to do things for one another. When Mr Chirac toyed again with the idea of a "core Europe" (some countries advancing swiftly towards closer integration), Mr Barroso and Ms Merkel were among those who squelched him. Mr Barroso decided not to fight for full liberalisation of services, which the commission had proposed, and instead accepted a diluted version passed by the European Parliament—much to the delight of Ms Merkel, since the compromise was largely designed by German MEPs carrying out her bidding. For her part, she has chosen not to oppose the opening of membership talks with Turkey, even though this is a neuralgic point for

her party.

An obvious parallel is the alliance of the 1980s between Helmut Kohl, the previous Christian Democrat chancellor before Ms Merkel, and Jacques Delors, then European Commission president, which helped to pave the way for the single currency, perhaps the biggest step so far towards European integration. But if anybody imagines that, some time next year, the Merkel-Barroso duo will get the EU to take another stride towards closer union, they may be sorely disappointed.

Ms Merkel is no Helmut Kohl. For her, European policy certainly matters, but it is not top of her agenda. Although she helped to broker the EU's budget deal last year, she, unlike Mr Kohl, does not have money to throw around to help persuade people to agree. Ms Merkel also finds herself in a minority on a couple of the biggest issues facing the EU (which Mr Kohl rarely did). Turkey is one, Russia the other. Most governments want Turkey in; most are desperately looking for ways to diversify away from Russian gas. Germany is dubious about Turkey, and is building a pipeline across the Baltic that will increase its dependence on Russia and upset its eastern neighbours.

In search of supporting actors

Mr Kohl and Mr Delors also needed other support, notably from François Mitterrand of France. A new French president will come next year, but it would be foolish to expect him (or her) to transform the EU. France is now the most pessimistic country about the future of the EU; a recent poll found almost nobody who regretted their vote against the EU constitution last year. Few in Brussels expect Gordon Brown, Mr Blair's likely successor, to turn into an EU enthusiast.

And just as Ms Merkel is not Mr Kohl, so today's Germany is not that of the 1980s, which accepted (albeit reluctantly) its role as “locomotive of the world”. Now Germany is a drag on growth in Europe, as it painfully improves its competitiveness through below-average wage rises.

Ms Merkel's domestic position, and thus her capacity to act in Europe's name, may now be at a peak. Tensions are building within her coalition. She has been riding high on the revival of business and consumer confidence, yet that confidence is being repeatedly contradicted by disappointing output figures. If Germany's recovery peters out and her honeymoon with voters fades, her ability to fight EU disenchantment in Germany will ebb too—and her political friendship with Mr Barroso will no longer be the strong influence it is now. That would leave the EU pretty much where it was last year, uncertain in the face of rising Euroscepticism and low growth.

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Executive pay

Lowering the bar

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Companies are busily reworking their executive pay schemes. In future, cashing in is likely to be easier

HEADLINES about fat cats and executive snouts in troughs have been rare of late. But this week Cable & Wireless, an ailing British telecommunications company, revealed a plan to pay its top managers up to £220m ($415m). Just two months earlier, the firm had announced the loss of 3,000 jobs. Cable & Wireless's bonus scheme sparked controversy because of its egregious size. But there are subtler shifts in the way bosses are rewarded elsewhere in corporate Britain that in many ways are more disturbing.

When the chief executives of Royal Bank of Scotland and Lloyds TSB, two of Britain's largest banks, missed out on bonus payments last year, members of the banks' compensation committees should have celebrated. It proved that pay had been successfully linked to performance. But instead of rejoicing, the pay committees of the two companies threw out their incentive plans and replaced them with new ones that look suspiciously as if they are designed to give managers an easier path to the trough.

Take Royal Bank of Scotland. In 2001 it presented shareholders with what was, for its time, a model incentive scheme. The plan, based on the premise that only exceptional performance should attract exceptional rewards, was designed to pay out only if two separate targets were met. First, earnings per share had to increase by 3% above the rate of inflation each year. Second, the bank's share price and dividends had to rise by more than the median average of ten of its competitors.

Royal Bank's new share plan, introduced this year, splits the performance measures. Instead of having to hit both targets to earn any payment at all, executives can take a shot at either. Hitting one pays out half, hitting both pays in full. “It gives them two bites at the cherry,” says Alan MacDougall of PIRC, a research and consulting firm that advises shareholders. Royal Bank of Scotland is not alone. Lloyds TSB has also introduced a split award, as has Barclays, another British bank.

Overall, just 37% of new pay plans introduced in the past year by Britain's 350 biggest companies used shareholder return as the main measure of performance, down from 47% a year earlier, according to Deloitte Touche Tohmatsu, an accounting firm. That is a sharp reversal of a trend. Over the preceding three years, the yardstick of relative performance grew in popularity; by 2004, it was the most commonly-used measure, according to PIRC. So what accounted for the rise of this measure and what explains the abrupt demise of payment schemes based on it?

Relative measures of performance blossomed in the early years of this decade. A rash of accounting scandals, such as that at Enron, put a premium on corporate governance and the protection of shareholders' interests. Stock options, which were blamed for encouraging a culture of greed in America, became less fashionable. There was greed before stock options, but they are a deeply flawed method of rewarding executives. Because their value

depends only on share prices, they reward bad bosses when markets are buoyant and punish good ones when markets fall.

But the fact that stock options fell from favour had as much to do with the market as it did with corporate scandals. With equity markets ailing, smart executives were quite happy to accept the new yardsticks. Relative performance measures, unlike options, can still pay out even when share prices are generally falling.

The bursting of the internet bubble also gave investors the upper hand for a while. Large numbers of eager, unemployed executives made it a buyers' market for shareholders, who began to dictate more onerous employment terms. That was reflected not just in the structure of incentive plans, but in pay inflation too. By last year, the rate of pay inflation for all executives in Britain's biggest companies was 7%. That is much lower than it had been a few years earlier, points out Independent Remuneration Solutions, a consulting firm. In America, too, companies moved from stock options to incentives based on longer-term measures of performance.

But pay moderation among British executives may now be coming to an end. Hedge funds and private-equity deals are proliferating, bringing with them rewards that make the offerings from public companies look stingy. So remuneration committees are approving more generous schemes to retain their best executives.

Transplanting pay plans from private-equity firms to public companies is dangerous, not least because doing so confuses two quite separate issues: how much executives ought to be paid and what their incentives should be. Managers involved in buy-outs are usually expected to put some of their own money at risk. And it is far easier to fire an executive in a private company than in a public one. Big rewards in private-equity firms are in part supposed to compensate for bigger risk. But more important, private-equity investors typically have direct control of the companies they manage and are able to set targets and structure incentives that align managers' interests with their own.

Royal Bank of Scotland, Lloyds TSB and Barclays say they decided to move away from relative performance measures because they can reward and punish executives for things beyond their control (such as the collapse of an incompetent or crooked rival). This is true, but it is also true that the new performance regimes tend to be less challenging than the ones they replaced. If executives miss one target there is a good chance they will be able to hit another. And, by moving from performance measures tested in tandem to solitary targets, companies make it easier for executives to manipulate performance to meet the target. An ill-advised acquisition, for instance, may boost earnings per share even as it causes the share price to fall.

Lastly, moving from measuring a company's performance against its rivals to using an absolute yardstick breaks the link between exceptional performance and exceptional reward. Because relative tests ask if executives are doing better than their rivals, they reduce the frequency of payments. Indeed, if all companies used them, only half of all bosses would get a payout in any given year.

On the other hand, when absolute performance tests are used executives simply have to clear a bar, and if it is set low enough they can all scamper over it. And that seems to be a rather frequent occurrence. Lloyds TSB, for example, asks only that its executives increase earnings per share by 3-6% above inflation, which means they may collect at least a portion of their bonus for growing just a little faster than the economy as a whole.

The move from relative measures of performance to absolute ones is worrying for another reason. Whereas relative performance is easily understood, some of the measures replacing it are not. Already, targets are proliferating. Phone companies are choosing to target sales growth and water companies are aiming at customer satisfaction, say pay consultants. All may be worthy targets in their own right, but the net effect of such proliferation is to force shareholders to rely on the judgments and impartiality of board remuneration committees. If only they could. A survey by PIRC found that only 46% of these committees are “fully independent”. Snouts up, everybody.

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Private military companies

Who dares profits

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Why Britain is good at producing private military companies

PRIVATE military companies, which provide armed guards for firms working in dangerous places, do not like being confused with mercenaries. The latter are useful for winning civil wars and toppling governments in resource-rich African states. Private military companies, though often staffed by ex-soldiers, are, by contrast, hired to protect engineers and guard government facilities. The blurring of this distinction in Iraq, where tales of gung-ho private military companies have multiplied along with a surge in demand for their services, has prompted the big British firms to find a way of distinguishing themselves from the rabble.

The result is a trade association, the British Association of Private Security Companies (BAPSC), which recently collected enough signatures to declare itself operational. Its charter includes un-mercenary promises to respect human rights and uphold British foreign-policy aims.

“British companies are viewed as being particularly good at this kind of work,” according to Chris Kinsey, an academic at King's College London who published a book on private military companies this week. While American firms tend to be larger than their British competitors (and tend to win the biggest contracts, which are handed out by the American government), British outfits grab more work from the private sector. Andy Bearpark, a former civil servant in the Department for International Development who chairs the BAPSC, reckons there are around 25 decent-sized security companies based in Britain. Their services are probably the nation's biggest export to Iraq.

Why are British companies so strong in this corner of the service sector? The people who run them cite three reasons. First, they entered the market early. The collapse of Britain's empire after the second world war led to a flurry of inquiries from newly-independent states in search of security and training nous from the former occupying power. Mr Kinsey says that the modern British private military company has its roots in mercenary operations in the Middle East and Africa in the 1960s.

Second, the infant industry was boosted by the many energy and mining companies in London. Three early security companies—Saladin Security, Defence Systems and Control Risks—were created to provide services to them in the 1970s. Control Risks was founded in 1975 after Lloyd's, a venerable London insurance market, began selling kidnap insurance largely for the benefit of workers in these dangerous industries.

Third, British companies recruit from the British army, whose soldiers are reckoned to be good at keeping the peace by showing force without using it. Kroll, an American company that has a security arm based in Britain, reckons that soldiers trained to patrol Northern Ireland's perilous streets without shooting civilians make the best troops for delicate overseas security work. Despite evidence of Brits periodically discarding their training when dealing with Iraqis, that reputation remains intact.

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The judges v the government

Wigging out

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From The Economist print edition

A war of words over human rights and public safety

"BARMY". That was Tony Blair's view of the High Court decision last week to allow nine Afghan hijackers temporary leave to remain in Britain. The men had fled the Taliban regime by diverting a passenger plane to Stansted airport six years ago. The Home Office tried to remove them, but the judge ruled they could stay until it was safe for them to return. Mr Blair described the court's decision as "an abuse of common sense".

An attack by a prime minister on a court ruling is a rare, if not unprecedented, event. But following a series of loud criticisms of government policy by a confident and seemingly activist judiciary, Mr Blair may have felt provoked. If so, he was not alone. Mr Justice Sullivan, the judge who presided over the hijackers' case, was equally cross with the government. "It is difficult to conceive a clearer case of conspicuous unfairness amounting to an abuse of power by a public authority," he said. The issue, the judge said, was not whether the government should take action to discourage asylum-seekers from hijacking planes, but whether it should be required to do so within the law.

The wrangle soon escalated into a dispute over the 1998 Human Rights Act, which incorporated the European Convention on Human Rights (ECHR) into English law. Most lawyers reckon the act, which was passed on Mr Blair's watch, simply codifies principles, such as the right to a fair trial and the right not to be tortured, that were already in English law.

Its opponents disagree. As well as encouraging hijackers, they say, the Human Rights Act has given undeserved rights to murderers and made it impossible to deport foreign criminals to countries where they might be in danger. The *Sun* newspaper, which has a Blair-like ear for public opinion, has set up a hotline for readers to call if they want to undo the act, and has printed mugshots of troublesome judges. The Conservatives have pledged to reform, replace or scrap it. Ministers hinted this week that the law may be rewritten to make it clear that collective rights (to live in safety, for example) are as important as individual ones.

Before the 1970s, relations between the judiciary and the executive were fairly gentlemanly, some would say undesirably cosy. That began to change with the rise of judicial review of administrative actions. The Human Rights Act marked a more sudden and (for the government) alarming break with tradition. Unlike their counterparts on America's Supreme Court, English judges cannot strike down a law. But they can now declare it to be incompatible with the ECHR, and, in practice, this means the government is obliged to change the law.

The extent of the judges' power was revealed in 2004, when the House of Lords (Britain's highest court) decided that the detention without trial of foreign terror suspects was unlawful. The government hurriedly rewrote the detention laws, only for another judge to rule that the new laws were incompatible with the ECHR.

Labour maintains that British judges give more weight to human-rights arguments than do judges in continental Europe. There is a sense of the grass being greener on the other side of the channel, but the government has a point. Last year the European Court of Human Rights in Strasbourg ruled on just 14 cases brought by British plaintiffs, suggesting that the ECHR has been so tightly woven into domestic law and culture that appeals are unnecessary. That compares with 57 cases from France, where the ECHR has been in effect for three decades, and 70 from Italy.

Judicial activism is not, however, the only reason for the clash between the judiciary and the executive. The other is increased government activism. As critics in the Conservative Party point out, the Home Office writes criminal-justice legislation at great speed. In a typical year two meaty bills appear. The attorney-general also intervenes in the courts by appealing against sentences that seem unduly lenient. He did so 75 times in 1995 and 122 times in 2005. That means stiffer sentencing all around, since no judge likes an appeal against his decision to be successful.

The odd thing about the dispute between the government and the judiciary is that it makes neither side really uncomfortable. The government is certain it is on the right side of the argument. In a purely political sense, it is: opinion polls consistently show that Britons value security over abstract rights. The judges, for their part, feel ever more strongly that they are the sole bulwark against a tide of ill-advised, populist measures. The dispute may be heated, but neither side is sweating.

This is a pity, because there are some obvious flaws in the criminal-justice system that are much more mundane than disputes over human rights. Witnesses are rarely informed of what happens to the perpetrators of crimes. Victims are often not told when prisoners are released. The courts treat defendants even more callously. Were the judges and the politicians to step down from their soapboxes and talk more sensibly, they might find that they agree on many of the problems, and even how to solve them.

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Inflation and interest rates

Doing the splits

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Divided monetary counsels reflect uncertainties about the labour market

THE Bank of England, which was freed to set interest rates nine years ago, marked the anniversary with an unusual three-way split in voting among its rate-setters. The majority of the Monetary Policy Committee voted on May 4th to keep rates on hold at 4.5%. But one member backed a cut to 4.25% while another called for a rise to 4.75%. It was the first three-way split since August 1998, and only the third in the history of the MPC.

The committee's divisions, revealed in minutes published on May 17th, reflected divergent views about the outlook for inflation. At issue is the margin of spare capacity that has opened up after a period when the economy has grown below trend. The main case for a rate cut, advocated by Stephen Nickell, was that continuing slack in the economy would keep domestic inflationary pressures at bay. The main case for a rate rise, backed by David Walton, was that any spare capacity was likely to be small.

If there is little slack in the economy, this should show up in the labour market. The latest figures suggest, however, that it is loosening rather than tightening. Unemployment has continued to rise, reaching 5.2% of the workforce in the first quarter of 2006, up from 4.7% a year earlier and the highest since 2002 (see chart).

Wages have also stayed subdued, rising at a rate well within the MPC's comfort zone. Excluding bonuses, average earnings grew by 3.8% in the year to the first quarter of 2006. Including bonuses, earnings growth edged up from 4.1% to 4.2%. On the basis of these figures, the committee can be fairly relaxed about the impact of higher energy bills on pay demands.

A surge in immigration is another reason to expect some slack in the labour market. Between May 2004 and December 2005, some 330,000 migrants from eastern Europe registered for work. Pay pressures have been restrained in sectors of the economy, such as agriculture and catering, where overseas workers tend to toil.

However, both the unemployment and pay figures may flatter to deceive. From a firm's perspective, what matters is total labour costs. These have been rising faster than earnings in recent years because of higher employer national-insurance contribution rates and extra payments into pension funds. These cost pressures suggest that the increase in unemployment is structural rather than cyclical, according to Ben Broadbent, an economist at Goldman Sachs. The jobless rate consistent with stable inflation has gone up, and, as a result, the apparent loosening in the labour market will prove illusory.

Furthermore, businesses that employ unskilled staff have been hit by steep rises in the minimum wage since 2003. These will continue in October when the adult hourly rate is due to increase by 6%, from £5.05 to £5.35. David Kern, economic adviser to the British Chambers of Commerce, gave warning on May 15th that the higher minimum wage would add to the jobless total.

An improved labour market has underpinned the economy's success in the past decade. But Labour has increasingly taken it for granted, piling burden after burden on firms, which has raised their employment costs. If the labour market begins to malfunction, that will mean a rougher economic ride ahead.

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School dinners

Let them eat kale

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Plans to improve school meals are causing havoc

JUST over a year ago, Jamie Oliver, a camera-friendly chef, called for a revolution in school kitchens. In a television series, he chronicled the decline in school lunches and showed that junk food-addicted children could be taught to tuck into what he calls “pukka nosh”. It proved a traumatic experience for the young gourmands, some of whom demonstrated for the return of chips and burgers. Mr Oliver's antics have also tweaked the government, upset some dinner ladies and shaken the catering market.

“Jamie's School Dinners” galvanised parents, who demanded that schools ditch grotesque inventions such as the Turkey Twizzler and adopt wholesome fare such as shepherd's pie and lentil soup. Worried about a looming general election, the government hastily responded to Mr Oliver's demands. Ruth Kelly, who was then the education secretary, promised to ban junk food in schools and asked a panel of experts to suggest nutritional guidelines.

The panel recommended that schools serve more freshly-cooked food containing less fat, sugar and salt. A sub-committee suggested tougher rules for vending machines and food served at breakfast and after-school clubs. The government's own targets are expected to be broadly in line with those of the panel.

Pressure from parents and the media is already changing school meals, not always in good ways. One effect is that the number of pupils eating school lunches has declined. The Local Authority Caterers' Association reports that the number of meals served has declined by 12.5% since last year, rendering some contracts unsustainable. It blames Mr Oliver's scare tactics for the exodus. More worryingly, some dinner ladies are threatening to strike. They complain that they are being asked to peel mountains of carrots and marinate meat to meet the demand for fresh food. But their schedule still assumes they just open packets and heat up the contents.

The government promised councils and schools an extra £280m over three years, but the providers, as well as the expert panel, say it is not enough. Last year some private contractors were shamed into pushing up standards. Now they say the money is insufficient to sustain the improvements. One caterer, Sodexho, threatened last month to put what the catering industry calls “shaped food products” (such as Fish Octopus) back on menus in Gloucestershire and Wiltshire if more cash was not forthcoming. The councils paid up. Other contractors are negotiating tougher deals. Initial Catering, for example, is demanding risk-sharing clauses, which trigger fines if the number of meals falls below an agreed level.

Some councils are struggling to attract any bids for catering contracts beginning in the autumn. Sheffield City Council has received one bid to run its school meals service, while Wokingham District Council had just two. Bracknell Forest Council has received no bids. Kent County Council, which broke up a single contract covering its 405 schools into 22 clusters with the objective of encouraging smaller players, received final bids for contracts covering just 70 schools. It is now entering another round of contract negotiations.

The 14 councils in England that have no school kitchens and simply give sandwiches to children who are entitled to free school meals are worst off. They are expected to provide hot food by 2008. One local authority describes the task as “enormous”; another says it is impossible.

Amid general upheaval, however, some companies are flourishing. Ashlyns Organic farm, in Essex, is training school cooks who now need to do more than heat up processed food. Simon Owen, a chef, says that he teaches them basic skills such as how to chop an onion. The farm already supplies and advises 25 Essex schools that run their own kitchens and is signing new contracts with schools in London.

Two weeks ago Mr Oliver won an award for his television series and again denounced the government's inertia on school meals. He has proved a good demagogue. But his revolution, like many others, has turned out to be a messy affair.

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Bagehot

An awful warning

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Gordon Brown is in danger of following the strategy that cost Al Gore the White House

THESE are dark days in Downing Street. But in Tony Blair's inner circle they can still enjoy a joke, even if the humour is increasingly of the gallows kind. The latest is that Gordon Brown, in his efforts to distance himself from the prime minister, is turning into Labour's Al Gore.

Mr Gore, it will be remembered, thought that his chances of winning the presidency would be improved if he could convince people that he had nothing to do with his party's most redoubtable election-winner since Franklin Roosevelt. What gives the joke extra piquancy is the rumour that Mr Brown is being advised by Bob Shrum. Mr Shrum is not well known in Britain, but his strategic insights have been put at the disposal of nearly every Democratic presidential campaign since George McGovern's ill-fated tilt at the White House.

That Mr Shrum, who the chancellor became close to while holidaying in Cape Cod, is a formidable operator is not in doubt. He masterminded the campaigns of about a third of the Democrats in the Senate and he runs a lucrative political consultancy. But Mr Shrum has been less successful with presidential candidates. So far, he has failed to get even one of his boys elected (he walked out on Jimmy Carter).

Apart from Mr Carter, the only Democratic nominee who reckoned he could manage without Mr Shrum at his side was Bill Clinton. Mr Blair and Mr Clinton have always identified with each other as the political charmers who invented the “third way” and dished the left of their own parties as comprehensively as they defeated their political opponents on the right. Egged on by Mr Shrum, Mr Gore ignored that winning strategy in 2000, blatantly appealing to the Democratic base with the slogan “the people against the powerful”. Mr Blair fears, with perhaps a hint of *Schadenfreude*, that Mr Brown, prompted by Mr Shrum, risks falling into the same trap.

Mr Blair has a point. In his impatience for the succession, the chancellor has put himself at the head of a motley crew which has other reasons to agitate for Mr Blair's exit. Rather too many of those who claim to be Mr Brown's supporters are fundamentally at odds with the centrist New Labour project. Every time one of them goes on television to argue that the time has come for Mr Brown to take over, the notion is reinforced that the chancellor will bring Labour back from the aberration of Blairism to its traditional (election-losing) ways.

By banging on about the urgent need for “renewal”, while failing to specify what he means by it, Mr Brown conveys the impression that he too thinks there is something rotten about Mr Blair's government. By providing tardy and less-than-fervent support for Mr Blair's more controversial policies, such as the reforms that are responsible for some of the current turmoil in the health service, the schools bill that is disliked by many Labour MPs and the building of a new generation of nuclear power stations, Mr Brown allows others to gain the (misleading) idea that he would do things very differently.

It is not surprising that Mr Blair thinks that his almost-certain successor is making a terrible mistake. He is exasperated by what he sees as Mr Brown's reluctance to help him do a few big things before he hands over the keys some time next year. But his analysis goes beyond the self-serving. As he sees it, the chancellor's forbidding demeanour and intense Scottishness—this week, an ICM poll found that 55% of the electorate in England was opposed to the idea of a Scottish prime minister—send out signals to middle England that can only be nullified by Mr Brown being even more New Labour than Mr Blair himself.

Mr Blair argues that the assumption of some of his colleagues that the main threat to Labour is from leftish voters deserting it for the Liberal Democrats is almost wholly misplaced. The evidence supports him. A study of the 2005 general election for the Fabian Society by Liam Byrne, a fast-rising young MP who has just been made the minister for police, argues that the danger for Labour comes from the right. Among the 100 most marginal Labour-held seats, the Conservatives were second in 88. Tellingly, Mr Byrne found that within the New Labour electoral coalition that brought Mr Blair to power, the biggest fall in support was among C2s (skilled manual workers). Their votes went largely to the Tories.

At the last general election, the swing from Labour in the south, home to 42% of the seats on the British mainland, was split evenly between the Tories and the Lib Dems. But if this month's local government elections are any guide, it will be the Tories who are most likely to benefit from dissatisfaction with Labour in 2009 or 2010. The threat to Labour is all the greater if, as seems likely, David Cameron succeeds in his aim of making it socially respectable to vote Conservative. A YouGov poll for the *Daily Telegraph* this week showed that in London, support for the Tories was up to 47% with Labour on 22%. Elsewhere in the south, Labour's support was only slightly higher. Resentment about poorly performing public services and high taxes that are used to subsidise Labour's northern and Celtic strongholds is the most plausible explanation. If that is right, Mr Brown is allowing himself to be positioned in precisely the wrong place.

The curse of Shrum

That Mr Brown should want to put some distance between himself and Mr Blair is understandable. Even when embroiled in the squalid details of the Lewinsky affair, Mr Clinton's approval ratings were twice as good as Mr Blair's are today. But he is going about it in a potentially suicidal way. Unless Mr Brown can convince the voters of southern England that he is on their side and feels their pain, about the best he can hope for after the next election is to govern without an overall majority. And the curse of Shrum will have struck again.

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Thinking big

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Banks the world over are scrambling to become larger, whether by organic growth or by mergers and acquisitions, says Robert Cottrell. But how much does size matter?

BORROWING and lending has become a fairly well-understood line of business, and a fairly well-managed one most of the time in most of the world. It is the banks themselves that are volatile, shifting shapes and strategies as furiously as their regulators will allow them in their efforts to win markets and market share. In China they are escaping state captivity by selling shares to foreigners and stockmarket investors. In Russia they are running wild, with balance sheets growing by 30-40% a year. In Japan three new “megabanks” have eaten 11 old banks and are now digesting them. In central Europe foreigners have bought or built 80% of the top local banks since the fall of communism.

In America the ten biggest commercial banks control 49% of the country's banking assets, up from 29% a decade ago. They are pausing for breath now, after a long merger binge encouraged by the deregulation of interstate banking and the removal of barriers between banks, insurance companies and securities firms. Non-financial companies are not meant to own banks, but even that is now being tested by America's biggest retailer, Wal-Mart, which wants a restricted banking licence.

This survey of commercial banking around the world is much preoccupied by questions of size and of ownership. Almost everywhere, big banks have been getting bigger through mergers and acquisitions as well as through organic growth. Is there a natural limit to this process of bank-eat-bank? Could the biggest bank of tomorrow be two or three or even ten times the size of a Citibank or an HSBC today, and if not, why not? And who benefits? It is not always the surviving bank's shareholders. One-half of recent bank mergers around the world have destroyed shareholder value, says Philippe De Backer, a partner in Bain & Co, a consulting firm. In America it is medium-sized banks that are prized most highly by the stockmarkets, partly because investors expect them to be bought dearly by the big banks.

One argument commonly used in favour of mergers, in banking as in many other industries, is the pursuit of economies of scale in areas such as procurement, systems, operations, research and marketing. But the gains from that in the mass production of financial services, though not necessarily illusory, can be elusive. There is a sizeable literature of academic papers claiming that economies of scale can be exhausted by the time a bank reaches a relatively modest size. A study of European banks in the 1990s, published by the European Investment Bank, put the figure for savings banks as low as €600m ($760m) in assets. More recent studies suggest far higher thresholds, up to $25 billion.

How the mighty have grown 1

World's top ten banks by assets*, $bn

2004		1995		1985	
UBS	1,533	Deutsche Bank	503	Citicorp	167
Citigroup	1,484	Sanwa Bank	501	Dai-Ichi Kangyo Bank	158
Mizuho Financial Group	1,296	Sumitomo Bank	500	Fuji Bank	142
HSBC Holdings	1,277	Dai-Ichi Kangyo Bank	499	Sumitomo Bank	135
Crédit Agricole	1,243	Fuji Bank	487	Mitsubishi Bank	133
BNP Paribas	1,234	Sakura Bank	478	Banque Nationale de Paris	123
JPMorgan Chase	1,157	Mitsubishi Bank	475	Sanwa Bank	123
Deutsche Bank	1,144	Norinchukin Bank	430	Crédit Agricole	123
Royal Bank of Scotland	1,119	Crédit Agricole	386	BankAmerica	115
Bank of America	1,110	ICBC†	374	Crédit Lyonnais	111

*Mitsubishi-UFJ Financial Group was formed in October 2005 with assets of $1.71trn †Industrial & Commercial Bank of China

Source: *The Banker*

Big banks might even dispute that there is a limit at all. But at some point diseconomies of scale will also start creeping in. Management will find it harder and harder to aggregate and summarise everything that is going on in the bank, opening the way to the duplication of expense, the neglect of concealed risks and the failure of internal controls. Something of that last problem afflicted the world's biggest bank holding company, Citigroup, in 2002-05, when it was rocked by a string of compliance problems. America's Federal Reserve reacted by telling Citigroup to suspend large acquisitions, but lifted the order in April this year when it judged that the company had got better controls in place.

Another argument commonly made for mergers is based on economies of scope, the proposition that related lines of business under the same ownership or management can share resources and create opportunities for one another. The basic economy of scope common to almost all banks is the taking of deposits on one hand and the making of loans on the other. The bank gets to re-use its depositors' money profitably. The skills and information useful on one side of the business tend to be useful on the other side too.

But does the same hold good when a retail bank is paired with, say, a corporate bank, an investment-banking division, a credit-card processor, an asset-management operation, private banking (for rich people), an insurance business or a foreign branch network? These businesses all overlap with one another to some degree, but so do lots of other businesses. The fashion for industrial conglomerates came and went 30 years ago. Will financial conglomerates be any more enduring? The bank holding companies that are building them clearly believe so.

A third reason for banks to pursue growth through mergers and acquisitions is one that is never used as an argument at the time, but is universally recognised as a factor. It is managerial ambition (which includes managerial error). Chief executives want the gratification of running a bigger company, or they fear that their own company will be taken over unless they grab another one first.

Managers can argue that the business environment is changing rapidly and that banks must seize the new market opportunities created by new technology or national deregulation or economic globalisation. Thus there is much talk in Europe now of a fresh wave of cross-border mergers and acquisitions within the 25 countries of the European Union, encouraged by the single European currency, the deepening Single European Market and the enlargement of the EU into central and eastern Europe. Shareholders may be the more easily persuaded because a takeover tends to look good at the time. The buyer books the new revenues immediately and cuts some overlapping costs. The acquisition premium goes straight to goodwill. It is only later that you find out whether the businesses are a good long-term fit.

And perhaps growth-hungry CEOs are wiser than their students and their critics know. The very big banks created in America over the past ten years have not been stellar stockmarket performers recently, but they may just be taking time to bed down and knit their management and computer systems more closely together. Their future results may transform the current wisdom about economies of scale.

Bigness may also have benefits not easily captured in studies of financial performance. One is the ability to place strategic bets on future markets, such as China, without putting the whole bank at risk. Another is regulatory capture, or the ability of the regulatee to influence the regulator. The bigger the bank, the more likely its home-country regulators and legislators will be to take its interests into account when drafting new rules, and the more likely they will be to judge it “too big to fail” in the event of a crisis.

Wait for it

Not, of course, that banks these days fold as often as they used to, which is another reason why strong banks go

shopping. Weak banks no longer fall into their laps, at least in Europe and America. Banks fail less often, partly because external conditions have been kinder. Developed economies around the world have become more stable over the past 20-30 years, save for Japan in the 1990s. Big shocks in the financial markets have become rarer and better managed. Recent medium-sized shocks, such as the downgrading of General Motors' credit rating last year, have been relatively easily absorbed. The financial markets have moved, you might say, from being a source of shocks to being shock absorbers too.

Such stability may engender its own instability if it encourages everyone to take on more risk in the belief that disasters are less likely to happen. But give credit, until then, where credit is due. Benign economic conditions have encouraged stable banks, and vice versa. Bankers and regulators in much of the world have arrived together at a pretty good model of how commercial banks ought to be run. Pressured by the demands of the capital markets for efficiency and predictability, they have also been pretty good about sticking to the rules and so avoiding catastrophic mistakes.

A version of that modern banking model is enshrined in a new set of rules, running to about 700 pages, that tell banks how they should weigh their risks, and how much capital they should keep on hand in case things go wrong. Big banks in most developed banking markets will be adopting the new rules, known as Basel 2, starting with the European Union next year. But America is hesitating. Some critics there think that the Basel 2 rules are at once too lax and too complicated; others think they discriminate too much between big and small banks.

One safe prediction is that Basel 2 and its risk-modelling methods will make banks even harder to understand than they are already. Ask a banker to explain risk management or credit derivatives or capital allocation to you, and the algebra will soon be spilling off the blackboard. The opacity of banks may count against them with investors. Mercer Oliver Wyman, a strategic and risk-management consultancy, says that publicly listed financial-services companies around the world were valued last year at an average of 14 times their profits, against a multiple of 18 for non-financial companies. But the discount has been shrinking, suggesting both that investors have got more optimistic about relative growth prospects for financial services, and that they think bankers have got better at banking, turning it into a generally less risky business.

A decade of deals 2

Top ten bank mergers and acquisitions since 1995

Target	Acquirer/*year*	Deal value $bn
UFJ Holdings	Mitsubishi Tokyo Financial Group/*2005*	59.1
Bank One	JPMorgan Chase/*2004*	56.9
FleetBoston Financial	Bank of America/*2003*	47.7
BankAmerica	NationsBank/*1998*	43.1
Citicorp	Travelers Group/*1998*	36.3
MBNA	Bank of America/*2005*	35.2
NatWest	Royal Bank of Scotland/*1999*	32.4
Wells Fargo	Norwest/*1998*	31.7
JPMorgan	Chase Manhattan/*2000*	29.5
Sakura Bank	Sumitomo Bank/*2000*	25.8

Source: Dealogic

This survey broadly agrees on both points. It considers the state of competition and consolidation in the developed markets of America, Europe and Japan. It looks at the big emerging markets of China, India and Russia, where the global winners and losers of the future may be decided. (China alone may account for over 25% of new global demand for financial services in the coming five years, says Alain LeCouedic, a partner at Boston Consulting Group.) It pauses to consider the intricacies of Basel 2, the virtues of pure investment banks and the cost of a Brazilian overdraft before drawing a conclusion which can be briefly summarised here: better banks tend to get bigger, but bigger banks are not necessarily better.

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Calmer waters

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After decades of wrenching change, American banks are now mastering new business models

THE introduction to this survey suggested two basic reasons why banks merge. The first was the hope of increasing shareholder value through economies of scale or scope. The second was to gratify managers who wanted to build an empire, or wanted to avoid being taken over in another bank's empire-building. In the America of the past decade or so bank managers were more than usually free to pursue empire-building ambitions because there was so little certainty where the industry was heading. Claims that they would increase shareholder value were hard for outsiders to dispute.

The strategic bets were being placed by guesswork because four big structural changes threatened to make earlier models of commercial banking obsolete: first, the growth of the capital markets, gathering pace through the 1980s; second, the arrival over the same period of powerful new information technologies; third, the deregulation of interstate banking by the Riegle-Neal act of 1994; and fourth, the removal of barriers between banks, insurance companies and securities companies by the Gramm-Leach-Bliley act of 1999, allowing the formation of diversified financial groups. These changes produced a wave of big mergers among American banks from the mid-1990s onward. The bigger the bank today, the more likely it is to be wildly different from what it was ten or 20 years ago. JPMorgan Chase, America's third-biggest bank by market capitalisation, is the product of mergers among 550 banks and other financial institutions, including 20 in the past 15 years.

Only now, after 30 years of bone-shaking structural change, during which the total number of bank holding companies and thrifts (or mortgage companies) has halved, has the pace of consolidation slowed. More banks are being created to take the place of some of those eaten up in mergers and acquisitions. The total number of banks seems to be stabilising at around 8,000, more than 90% of them small local ones with assets of less than $1 billion. No bank has failed since June 2004, an historic record, says the Federal Deposit Insurance Corporation (FDIC), which insures deposits at banks and savings associations. One reason is that 2005 was the fifth consecutive year of record profits for American banks. Last year they made $134 billion, 9.6% more than they did in 2004. Return on equity, or profit as a percentage of capital—the key measure of a bank's profitability for its shareholders—fell slightly, but remained close to 60-year highs. It was down mainly because banks were making so much money that they could afford to plough capital back into their balance sheets, boosting their capital-to-asset ratios to the highest levels seen since 1939.

The capital markets have proved a containable threat. They did take market share away from the banks: between 1974 and 1994, the proportion of non-financial debt advanced by America's commercial banks declined from 30% to just over 20% (see chart 3). But since then the banks' share has held steady. And because American borrowing and lending was increasing sharply over that period, the amount of credit provided by the banks kept growing in absolute terms at roughly the same speed as the economy as a whole, even while their market share was shrinking.

The growth of capital markets also created new opportunities for the commercial banks. They could securitise and sell off loans, taking arrangement fees without tying up capital. By 2001 roughly 18% of their non-interest income came from selling and servicing securitised assets. With the collapse of the wall between commercial banking and underwriting in the late 1990s, commercial banks could plunge into investment-banking markets.

Predictions in the 1990s that banks would lose their retail customers to internet-based competitors were also wide of the mark. Branch networks have proved to be indispensable as the place where customers go to open accounts and where they can most easily be charmed into buying more services. In America the number of branches grew by 2.5% last year, and banks have also been spending heavily to improve existing branches. The biggest internet-only deposit-taker in America, ING Direct, positions itself explicitly as an add-on service for people who already have a conventional bank account elsewhere. Investment in branches may get less attractive if the yield curve stays flat, reducing the profit a bank can make by lending its depositors' money on to long-term borrowers. Even so, any American bank with branches to sell has been finding a queue of willing buyers.

The next lot of worries

There are still fears that new competitors will eat the banks' lunch. The use of mobile telephones for payments might open the way for telephone companies to compete with banks in holding balances and running payments systems. But that would be a big departure for the phone companies. They would need to take on and manage much more financial risk, and accept new regulatory burdens. That may yet happen; but more likely, they will turn to banks to do the job.

Another current worry among American banks is the effort by Wal-Mart, the world's biggest retailer, to get a licence for an industrial loan company, a state-chartered institution which is a bank in all but name. Small banks fear that a Wal-Mart bank would put them out of business. Big banks fear losing big companies' payments business if Wal-Mart gets its way and other firms follow suit.

The big banks are right to worry about Wal-Mart. The small banks may be overdoing it. Most Americans already have a choice of banks, big and small, within driving distance. They might use a small local bank because they value the proximity, the personal service and the local roots, and are unlikely to turn to Wal-Mart for those qualities. In any case, Wal-Mart should have the chance to compete. The historic separation in America between banking and commerce reflected the fear that an industrial company would drain the money from any bank allowed to fall under its sway, and manipulate its lending. But that is what regulators are there to prevent. And if securities houses and insurance companies are free to tie up with banks, as they have been since 1999, it is hard to see why supermarkets or anybody else should be treated less favourably.

A third worry for American banks is the flattening of the yield curve, which is another way of saying that short-term interest rates have risen almost to the level of long-term ones. That makes it much harder for banks to extract a profit from their basic strategy of borrowing short from their depositors and lending long to companies and housebuyers. Worse still, a flat or inverted yield curve often presages a recession. That would mean demand for loans would grow more slowly, existing borrowers would have less money for repayments, and assets used as loan collateral might fall in value. Banks would have to make more provisions against their loans, cutting into profits.

Not like the bad old days

Yet these are trifles when compared with business conditions of 15-20 years ago. The sky above the banks may not be a perfect blue, but the clouds are smaller and the visibility is better.

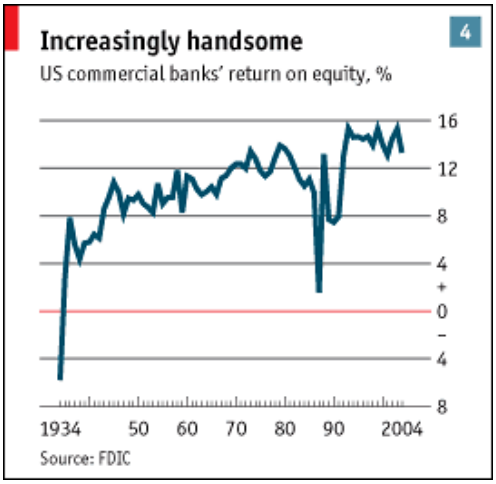
Each of the big banks at the top of the industry has its own distinctive mix of businesses; all have moved some distance from the traditional banking strategy of holding assets on the balance sheet. They securitise loans and sell them on in the capital markets, or syndicate them to other banks, blurring the distinction between bank as lender and bank as trader. Ken Lewis, chairman and chief executive of Bank of America, says that he and his colleagues are “marrying our huge distribution network for originating loans with capable capital-markets distribution, or, to put it more simply…saying ‘yes' to more customers, and getting those loans that would not otherwise fit our risk parameters into the hands of investors who accept that risk at an appropriate yield.”

In the past decade big commercial banks have also become buyers and sellers of derivatives, such as credit-default swaps and interest-rate swaps, sometimes in terrifying volumes, both for profit and to hedge their other assets and liabilities. The billions and trillions involved in derivatives trading are liable to worry outsiders, though the banks claim to be in control of the situation. True, the net position of a bank in the derivatives market may not be a very big number by the standards of its balance-sheet totals at any one time. The real danger here is that, given the volume of gross trading over time, any managerial or operational failing could very quickly snowball into a much

bigger problem.

The big banks have learnt to love their retail customers, all the more so because their big corporate borrowers have moved so much of their borrowing to the capital markets. Between 1984 and 2004 commercial and industrial lending shrank from 38% to 18% of American banks' loan books. Over the same period, residential mortgage lending rose from 12% to 31%.

Retail banking customers, including small businesses, provide just over half of commercial banks' revenues. Getting and holding a customer's demand deposit account is only the start of a long campaign to sell other products and services, ranging from asset management and credit cards to mortgages and safe-deposit boxes. Wells Fargo, widely considered to be among the best of America's big retail banks, pushed up the average number of products it sells each customer from 4.6 at the end of 2004 to 4.8 at the end of 2005, and in the longer term hopes to sell each of them at least eight. Online banking has become a new and more profitable way for the banks to serve their existing customers, rather than a threat to their existence.



By selling products for which they can charge fees, rather than merely making loans and holding them, banks can reduce their reliance on interest income, generated by charging more to lend money than they pay to borrow it. The bigger the bank, the more fee income it usually has. At Citibank, fee income amounts to almost half of all revenues; for a one-branch savings bank, the figure will be tiny. That ought to be working to the big banks' advantage. The difference between the average cost of a bank's funds and the average return on its loans and investments is low by historic standards, and getting lower.

A puzzle here is that the size of a bank, and the diversity of its income, impresses the stockmarkets less than you might expect. Roughly speaking, the bigger and the more complicated the bank, the smaller the premium over book value which it commands in the stockmarket. Citigroup and JPMorgan Chase have underperformed the Dow Jones Industrial Index over the past five years. Bank of America has outperformed it, but still trades at “a 30% discount to the sum of its parts”, says one expert.

One reason may be that the financial engineering which produced these very big banks is taking time to bed down, and that in a few more years the economies of scale and of scope will come through. There are patchwork quilts of inherited and incompatible computer systems to integrate; huge workforces to rationalise and motivate; and research to be done on which products and services will cross-sell to which new customers.

Why investors hold back

But even then, two basic problems will remain. One is that investors tend to shun opacity, and big diversified financial institutions will always be intrinsically hard to understand. A second problem is that non-interest earnings, especially those from trading, are seen by investors as more volatile than interest earnings, and, as a general rule, the more volatile the earnings, the lower the valuation of the company. JPMorgan Chase's chief executive, James Dimon, hopes he can bring down the volatility of trading earnings. That would be quite a trick to pull off.

It is hard to imagine further mega-deals that would make the biggest American banks even bigger—but then the same was true ten years ago. And besides, as of April, Citigroup has been back in the game. Its chairman, Charles Prince, bantered at a conference in February that “we are more likely to be ready to do JPMorgan in a few years than JPMorgan will be ready to do Citigroup,” although, he insisted in his next breath, “it's not likely that either one will happen.”

Alternatively, you might think that JPMorgan Chase would be better balanced with a global retail network, in which case a merger with HSBC would be the possible big-bang solution. Or that the pure investment banks are relatively cheap, and that sooner or later a commercial bank is going to experiment with buying one.

But far more likely, in the near term at least, is that America's big banks will aim to go on growing by buying small and medium-sized banks, extending their branch networks and capturing more of the retail customers that they have learnt to serve so profitably. In the meantime, they can be fairly sure that nobody else is going to take them over against their will. To that extent, they have won their strategic bets.

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The risk-takers

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Investment banks are a race apart

THE bigger the commercial bank, the bigger the investment-banking operation it is likely to have under its wing, underwriting stocks and bonds, advising on mergers and acquisitions, and trading in securities and commodities both on the bank's own account and on those of other institutions. This is where the bank does its main business with big corporations, which have moved more and more of their borrowing to the capital markets over the past two or three decades. Citigroup had the biggest investment-banking revenues last year of any institution save for the biggest of the pure investment banks, Goldman Sachs.

The pure American investment banks are a well-matched and well-consolidated bunch. There are five in the top tier: Goldman, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns. All began this year with record or near-record profits. Goldman Sachs reported a 39% return on equity in the first quarter, the others from 19% to 27%.

By Goldman's reckoning, it was a quarter when everything came right. David Viniar, the firm's chief financial officer, said the conditions in most main financial markets were the best in 25 years. But as to exactly what it was that Goldman did so profitably, nobody could be sure. More than half the firm's revenues were accounted for by a single line, labelled “FICC”, for trading in fixed income, currencies and commodities.

Goldman and the other big investment banks have worked furiously hard to ensure that their risks are as efficiently hedged and as finely priced as management and mathematics will allow. Risk-taking is their core business, the thing that they get paid for—unlike retail banks, whose core business is distribution.

But if you make a 39% return on equity when everything goes right, what if things go wrong, and a hedge fund or two blows up in your face? Such worries help account for the relatively lowly valuation of the pure investment banks in the stockmarket. Early this year they were priced around 11 or 12 times earnings and 2.5 times book value, not far out of line with much less profitable commercial banks. Given the much bigger market capitalisation of the largest commercial banks, the overlap of business lines and the propensity of commercial banks to merge in search of new economies of scale and scope, is it only a matter of time before the big commercial banks start buying up the investment banks too?

Not necessarily. One reason is that the commercial banks are trying to reduce the volatility of their earnings, not increase it. Another is that the pure investment banks are packed with very highly paid, headstrong individuals who would be hard if not impossible to accommodate within any other company's culture. The average pay and benefits at Goldman for all employees, right down to drivers and doormen, in the first three months of this year alone worked out at $220,000 per head, more than twice what a big commercial bank pays its average employee for an entire year. To graft a Goldman or a Lehman on to a commercial-bank culture would threaten chaos. Which is not to say that, sooner or later, somebody might not try it.

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One Basel leads to another

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The difficult business of drawing up new international banking rules

AS BANKS get bigger, they also become smarter. That, at any rate, is the theory underpinning a new set of rules on risks and capital for banks around the world, formally called the "International Convergence of Capital Measures and Capital Standards" and informally "Basel 2". The code has been drafted by the Basel Committee on Banking Supervision, an offshoot of the Bank for International Settlements (BIS), which supports and co-ordinates the work of leading central banks around the world. It is a gentlemen's agreement among leading regulators which all countries with international banks are encouraged to adopt, but which relies on national law for its implementation.

Beauty parade 5

Large banks' capital ratios and profitability
2002, as % of total assets

	Equity capital	Pre-tax profits	
Country	2002	2002	2000-02
United States	6.34	1.66	1.67
Spain	5.07	0.93	1.15
Australia	4.91	1.49	1.61
Italy	4.68	0.48	0.81
Britain	4.49	1.11	1.34
Canada	4.32	0.61	0.3
France	3.94	0.58	0.72
Japan	3.15	0.04	-0.25
Germany	2.63	0.05	0.29
Switzerland	2.18	0.08	0.49

Source: FDIC

One striking feature of Basel 2 is its principle that banks should have the option to decide for themselves where they think their big and their little risks lie, and then to allocate their capital accordingly, subject to national regulators' rules and national laws. Another feature is that it will probably allow many big banks to reduce the capital needed for their current balance sheet, in some cases quite sharply.

Europeans, by and large, are keen to get on with it. The European Union has passed legislation to implement Basel 2 next year. Americans, by contrast, are worried on three counts. First, they think the rules are too slack, allowing banks to reduce capital too far. Second, they reckon that American banks will not be able to implement the rules reliably without at least another four years' practice, if ever. Third, they fear that the rules will give the biggest banks too much of an advantage over small banks.

Those worries have persuaded America to adopt Basel 2 later and more gradually. International banks with headquarters in America and subsidiaries in Europe, and vice versa, can only guess how they will reconcile European and American regulatory requirements when the EU works to Basel 2 rules and America does not.

The Basel rules have their origin in the failure of Germany's Herstatt Bank in 1974. Herstatt defaulted on contracts with banks overseas, highlighting the need for more international co-operation among banking regulators. The Basel Committee published its first "Basel Capital Accord", now known as Basel 1, in 1988.

Recognising that some loans and investments were less risky than others, the Basel rules "weighted" them accordingly. For example, all loans to companies were assigned a weighting of 100%, but loans to banks in rich Western countries had a risk weighting of just 20%. A bank which had $8m in capital and lent $100m to companies was at the limit of its lending capacity if it observed the minimum capital requirement of 8% recommended by the Basel Committee. But a bank which lent only to other banks could lend $500m before reaching its limit.

A bigger, better rule book

These Basel 1 rules soon came to be seen as much too crude in the way they weighted risks, with one category for all corporate loans, another for all sovereign loans and so on. Work on a new and more flexible framework, Basel 2, started in 1996, and a draft was published in June 2004. The new code was designed for internationally active banks. In America, this may mean only ten to 20 banks. In the European Union all banks will have to implement Basel 2, so that they can be treated equally, as European law requires.

Basel 2 invites banks to choose between two approaches when calculating credit risk and capital allocation. The simpler method, the so-called "standardised approach", is designed for smaller banks with less sophisticated risk-modelling and risk-management systems. It requires banks to use the risk assessments provided by accredited credit-rating agencies when giving a risk weighting to their loans and investments.

Bigger banks with more sophisticated risk-modelling and risk-management systems can opt for what Basel 2 calls the "internal ratings-based approach", or IRB. The IRB allows a bank to use its own internal historic data to calculate the riskiness of its loans and investments. To do this calculation, the bank needs to be able to estimate

the probability of default within one year for each borrower; the bank's potential exposure at a default; the bank's potential loss from a default; and, in the absence of a default, when the borrower will repay.

In addition to these risks of default, Basel 2 requires banks to provide capital against what it calls “operational risk”, meaning the risk of losses from crashing computer systems, natural disasters or rogue traders. But here calculation shades into guesswork.

In allowing banks to do more of their own risk assessment under IRB, the Basel rules rely on national regulators to ensure that banks are up to the job and are doing it diligently. That is a tall order, at least initially. National regulators also need to look out for problems which may not be easily caught by assessment of default risk alone. A bank with a very large portfolio of fixed-interest securities and derivatives, for example, would lose a bundle if interest rates went the wrong way.

The Basel 2 rules count on “market discipline” to do some of the work of keeping banks in line. Banks must publish details of their assets and liabilities and of the models they use to calculate credit and operational risk. As George Kaufman, professor of finance at Loyola University in Chicago, has pointed out, this is not really market discipline, but transparency and disclosure. If regulators wanted to increase market discipline, they could do so by abolishing deposit insurance, which would make depositors think more about their choice of bank, or by requiring all banks to issue publicly traded subordinated debt.

America's hesitations over Basel 2 were increased by a study last year of how its banks might calculate current risks and capital requirements using Basel 2 rules. On average, the banks thought that applying Basel 2 rules would allow them to decrease their regulatory capital by 15%. They reached that conclusion using calculations of risk falling “well short of the level of reliability that will be necessary to allow supervisors to accept those estimates for risk-based capital purposes”, said John Dugan, America's Comptroller of the Currency, whose job includes bank regulation. Different banks gave weightings ranging from 5% to 80% for seemingly identical risks.

And even if banks manage to standardise their calculations, the Basel 2 rules will still be a cause for concern, according to Donald Powell, the FDIC's chairman. Its formulas for regulatory capital, he told the Senate, “are inherently calibrated to produce large reductions in risk-based capital requirements”, implying “a far lower standard of capital adequacy than we have in the US today”.

A third concern among America's thousands of small banks has been that Basel 2 would give big banks an unfair advantage. Big banks using the IRB approach would be updating their risk calculations second by second, laying off assets that tied up a lot of capital and adding ones that tied up much less. Small banks without the same information systems, and without the same scale and diversity of assets in which to trade, might end up with a concentration of the worst-priced risks without even knowing it.

To allow more time to deal with these concerns, America plans to implement Basel 2 only from 2008, and with a three-year transition period. No American bank will be allowed to use Basel 2 as a reason for reducing its risk capital by a total of more than 5% before 2009, 10% by 2010 and 15% by 2011. Small banks will get a new set of rules more flexible than those of Basel 1 but much less complicated than those of Basel 2, including more categories of risk, more use of external credit ratings and more scope for using collateral and guarantees to reduce risk weightings.

American regulators will also reserve the right to keep a basic minimum equity capital ratio for all banks, currently set at 4% of assets regardless of risk weighting, and they will go on prodding banks to keep their capital levels well above any statutory minimum. Most banks do that already in order to impress customers and shareholders as well as regulators. The argument here is that capital signals the trustworthiness of a bank. Having lots of it on the balance sheet keeps down the bank's cost of funds. Certainly, international comparisons suggest that high capital ratios have done no harm to American banks' profits in recent years (see chart 5 above).

America returned to strict capital requirements for all banks in 1984, after Continental Illinois, the country's seventh-biggest bank, lost half its funds overnight. Until then, the biggest banks had not been subject to any minimum capital requirement, in the belief that they could be trusted to manage their own balance sheets. Times have changed, and banks too. But Americans can be forgiven if they worry that banks, at any rate, have not changed enough.

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What single market?

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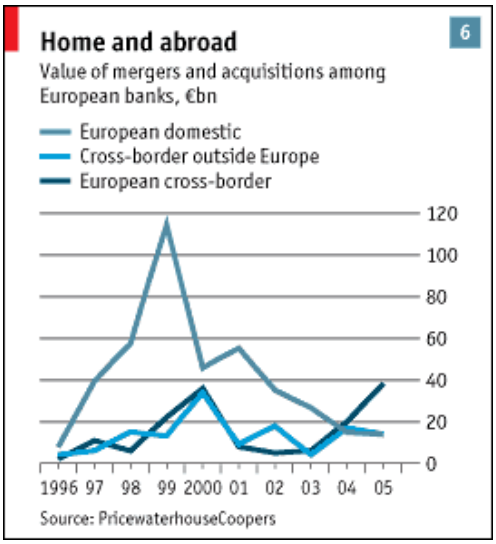
But western European banks are at last beginning to do more cross-border business

EVEN in Frankfurt the bankers have a spring in their step. A cyclical recovery in the German economy and in German banks' profitability has been under way since mid-2005. Deutsche Bank, Germany's biggest, reported a return on equity of 25% last year, up from 16% in 2004, helped by a very good year in its big investment-banking operations. Merrill Lynch, an American investment bank, predicts an average 18% return on equity for big publicly listed European banks this year. If so, that will mark the ninth straight year of strong profitability for the industry.



Like American banks, European banks have benefited from benign external economic conditions. Unlike American banks, they have held their ground pretty well against the capital markets as providers of finance to big corporate borrowers. According to figures compiled by the IMF, the total assets of European banks amounted to $28 trillion in 2004, two-and-a-half times the total value of the market in private-sector debt securities, and three times the capitalisation of Europe's stockmarkets. In America, by contrast, the sum of bank assets was $8.5 trillion, roughly half the size of the market for private-sector debt securities and half the capitalisation of the country's equity markets.

The European Central Bank calculates that the cost of bank borrowing has been very close indeed to that of market-based debt over the past five years, and often slightly below it. Last year non-financial corporations in Europe increased their bank borrowings more than twice as fast as they did their issues of debt securities. Analysing past data for bank lending and private debt issues in the euro zone, two economists, Fiorella De Fiore of the ECB and Harald Uhlig of Humboldt University in Berlin, concluded that banks do proportionately more lending to companies in Europe because it is harder for the public at large to get reliable information about the creditworthiness of borrowers. The implication is not so much that banks are better at their job in Europe, rather that capital markets are less efficient. An alternative argument might be that European banks have been underpricing their corporate loans, but that view is contradicted, at least for recent years, by low rates of defaults and provisions.

Helped by consolidation within Europe and by acquisitions in America, Europe's banks have gone on getting bigger over the past 10-15 years, in some ways more strikingly so than their American counterparts. The biggest American bank, Citigroup, has capital equivalent to about 1% of America's GDP. The biggest Dutch bank, ING, is at 6.5% of Dutch GDP. The biggest Swiss banks, UBS and Credit Suisse, each have capital equivalent to about 13% of Swiss GDP. As Jean Dermine, professor of banking and finance at France's INSEAD business school, points out, the bail-out of Crédit Lyonnais cost French taxpayers twice the bank's published capital in 1991. Not that any big European bank is going to repeat that spectacle, but the biggest European banks now really are too big to fail.

However, Europe's banks have not got bigger in quite the way that has long been predicted. Despite all the laws and rules enacted since the mid-1980s to give the European Union a single market in goods and services, including banking and finance, banks have obstinately gone on getting bigger within their home countries. They have merged at home much more enthusiastically than they have merged or branched or sold services across borders.

This is not to say that the single market and other EU legislation has had little effect. It has encouraged and forced wide-ranging deregulation of banking and other financial services and removed interest-rate controls, capital controls and barriers between banking and insurance and stockbroking. This deregulation helped bring about a huge expansion in the ratio of banking assets, says Mr Dermine. In the Netherlands, the ratio of banking assets to GDP more than tripled between 1981 and 2003. In Britain, a centre for international banking, it almost quadrupled.

In the five years after Europe launched its common currency in 1999, the value of financial-industry mergers within the EU was roughly equal to that within America, at *euro*500 billion against *euro*580 billion, even without much in the way of cross-border acquisitions. Given the smaller size of Europe's markets, that implies a wave of European consolidation at least equal to the American one provoked by the Gramm-Leach-Bliley

act of 1999, which brought down barriers between banking and insurance and securities companies.

Now there are signs that big cross-border bank mergers in Europe may be getting easier, or at least more attractive. The past three years have seen three of Europe's biggest such deals to date, and the first to take place between big banks from big countries. Oddly, this has come just as the political momentum behind European integration has been slowing in all countries, halting in most and even reversing in some, such as France and Poland.

One reason banks may be looking abroad more now is that consolidation in their home markets has started to reach natural limits. Between 1990 and 2004 the market share of the top five banks rose from 26% to 54% in Italy; from 35% to 46% in Spain; from 52% to 66% in France; from 66% to 82% in Britain; and from 78% to 89% in the Netherlands, according to Boston Consulting Group. Germany is something of an outlier, with the top five banks holding just 22% of the market, but much of that market is in the hands of public-sector and co-operative banks immune to private takeover. The concentration of some types of retail banking is much higher still. Across all EU countries, the top three mortgage banks in each country have, on average, two-thirds of the market there.

Love thy neighbour 7

Top ten European cross-border bank mergers and acquisitions since 1995

Target	Acquirer/*year*	Deal value $bn
HVB Group	UniCredit/*2005*	22.3
Abbey National	Banco Santander Central Hispano/*2004*	16.8
Générale de Banque	Fortis Group/*1998*	12.7
Banca Nazionale del Lavoro	BNP Paribas/*2006*	11.0
Crédit Commercial de France	HSBC Holdings/*2000*	10.7
Banca Antonveneta	ABN AMRO/*2005*	7.2
Bank Austria	HVB Group/*2000*	6.7
Merita	Nordbanken/*1997*	4.7
Banque Bruxelles Lambert	ING/*1997*	4.7
Unidanmark	Nordic Baltic Holding/*2000*	4.6

Source: Dealogic

Open Sesame

Another reason for banks to look abroad may be that even protectionist governments in Europe are losing the political will, or the legal certainty, needed to defend national banking sectors. When the European Commission asked banks early last year why they did not attempt more cross-border acquisitions, one of the most common replies was that they expected political interference in takeover bids. And indeed, when two foreign banks, Banco Bilbao Vizcaya Argentaria (BBVA) of Spain and ABN Amro of the Netherlands, launched bids last year for two Italian banks, Banco Nazionale del Lavoro and Banca Antonveneta, the Bank of Italy tried to frustrate them by promoting rival domestic bids. But under pressure from the European Union and from business lobbies, it gave up and its governor resigned. The banks went to foreigners. ABN got Antonveneta. BNL was bought this year by another foreign bank, BNP Paribas of France, after BBVA had dropped out.

BNP Paribas's chief executive, Baudoin Prot, said later that his bank had swooped into the bid battle because it

believed that cross-border consolidation among European banks was under way, there were “limited partners” and the barriers to success were high. He was pleased to have taken BNP Paribas into a “relatively exclusive club of banks with retail networks in more than one European country”.

Mr Prot's words were not without irony, because even now it would take a very bold foreigner to think of launching a hostile bid for any big French bank. Even so, the Italian drama must have had some demonstration effect across Europe in addition to its impact on Italy. The chances of successful political interference must now be lower than they were, so long as banks are big and bold enough to face up squarely and publicly to governments.

The segmentation of European banking cuts deepest where the banks are most visible, in their retail operations. The capital markets, trading in debt issues, equities and credit derivatives, have become well integrated since the launch of the common currency, partly because so much of the running has been made there by American investment banks operating out of London with a Europe-wide mandate. Big loans cross borders easily too, because big borrowers shop around and because banks syndicate (ie, divide up) the loans among themselves. The European market in syndicated loans expanded by 35% last year, almost twice the global growth rate.

Retail banking has been confined much more within national borders, mainly because governments have insisted on regulating it heavily, ostensibly to protect small savers. Banks have worried whether they would appeal to foreign customers, and whether foreign tax laws or foreign regulators would trip them up.

The first of the recent big cross-border bids, by Banco Santander of Spain for Abbey National of Britain, may have helped to ease some of the banks' fears. British critics mocked Santander's ambitions, but the Spanish bank has done well with the deal. Last year it cut Abbey's costs by £224m, equivalent to almost 10% of revenues. Trading profits rose by almost one-half. Santander expects more productivity gains from integrating computer systems.

The truth which Europe may now be in the process of discovering, or admitting to itself, is that there are very few national differences in what people want from their banks. Everyone wants safety, reliability, convenience, courtesy, clarity and, subject to all this, a good return. It is also common to find a “home bias” among households when it comes to placing their savings. They want to be sure they can get attention when something goes wrong. But a foreign bank with a well-run local branch can provide this better than a local bank with an awful call centre half way round the globe.

The more that local banks are hollowed out by outsourcing and offshoring of customer services and back-office work to low-wage countries in Asia and eastern Europe, the weaker the economic arguments against cross-border mergers will become. A foreign firm may have trouble staffing call centres with people who can speak Danish or Slovak: some things will have to stay local. But once a mortgage loan or a credit card has been sold, the economics of servicing it will be the same wherever it originated.

So what will happen if banks, persuaded at last that cross-border mergers work, all pile into the market at once? Prices, already high, will rise further, as they have done in eastern Europe (see article). That will be good for shareholders in target banks, but perhaps worrying for the banking system as a whole, especially if banks overpay with capital taken off their balance sheets thanks to Basel 2. Europe's leaders have spent years talking up the need for banking integration. Success may yet see them trying to talk it down again.

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Gone shopping

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Austrian banks have led the way in eastern Europe

SINCE the collapse of communism, foreign banks have bought up roughly 80% of all the banking business in the new central European member countries of the European Union. With hindsight, those that bought early now look very clever. The markets are still relatively small, but growth rates are high, and so are profit margins.

The surprise is who got in first. Germany was the region's biggest trading partner, but German banks were busy at home with the shocks and costs of unification. They left central Europe to their smaller Austrian neighbours. Raiffeisen, a co-operative banking group, went into Hungary in 1987 and was in seven more countries by 1998. Hard on Raiffeisen's heels came Creditanstalt and Bank Austria, which merged in 1997 (only to be bought in 2000 by HVB of Germany, which last year was bought by UniCredit of Italy). A third Austrian bank, Erste, joined the fray with its purchase in 2000 of Ceska Sporitelna, a Czech bank.

As the Balkan wars subsided, more countries became bankable. Raiffeisen bought into Bosnia in 2000, Serbia in 2001 and Albania in 2004. But by now other foreign banks were in the race, chasing a dwindling number of prospects, and prices spiralled upwards. Last year Raiffeisen paid more than four times book value for a bank in Ukraine, Bank Aval; and Erste paid 5.8 times book value for a Romanian savings bank, Banca Comerciala Romania, beating off five other bidders.

“We are operating in markets with asset growth of 40%, sometimes 50%, a year,” says Herbert Stepic, chief executive of Raiffeisen International Bank, “and when you apply this to the valuation model it is not so hard to understand why banks are purchased at these price levels.” Others are less sure. “If you pay five times book value, that requires extremely high expectations about key criteria,” says Wilhelm Nuese, a director of Commerzbank. “There must be a business model in place, economic growth, customer growth, profit growth. In Ukraine you would need [economic] growth of 7-8% a year for the next 12 years , and present growth averages less than 4% annually…Are these prices reasonable? If you ask me, they are not,” says Mr Nuese.

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A land of limited opportunities

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Russian banks worth having are few and far between

IF A big bank in America were growing at the same speed as the whole Russian banking system in recent years, the inspectors would be all over it. The Russian system's total assets in nominal terms expanded by 37% last year, corporate lending was up 31%, retail deposits were up 39% and consumer lending almost doubled for the third year in succession. “The story in Russia is one of real growth and real potential. By any conventional measure, Russia is way underbanked,” says George Cardona, a former HSBC executive who recently joined the board of MDM, a Russian private bank. Even Sberbank, Russia's huge but slow-moving state-owned savings bank, has roughly tripled its total assets and increased its loans to customers sixfold in the past five years.

In many ways such growth is good. After struggling through the chaotic 1990s and touching bottom with a big currency devaluation and a debt default in 1998, the whole Russian economy now has to make up for lost time. Russia's banking assets at the end of 2004 were equivalent to 45% of GDP, compared with a range of 55-120% in Poland, Hungary, the Czech Republic and the Baltic states. The mortgage market in Russia is in its infancy, with outstanding loans worth perhaps $2 billion in total. It could be ten times that amount by 2010, says Natalya Orlova, an economist with Alfa Bank in Moscow.

In other ways, such growth is worrying. It tends to mean that credit quality is falling. Banks are lending more and more to borrowers that they know less and less well. Fast growth also puts pressure on banks to keep up their capital ratios. Until recently Russian banks could find the capital they needed mainly from retained profits. But now, according to Fitch Ratings, a credit-rating agency, profits are no longer quite enough to do the trick. The banking system's regulatory capital (measured as a share of total assets) declined by almost three percentage points between the first quarter of 2004 and the third quarter of 2005. It remained comfortably above the 10% capital ratio fixed by the central bank, but some institutions were getting close to that level and had to rein in new lending.

To go on getting bigger, Russian banks need more money from outside investors. Given the shallowness of the country's domestic capital markets, that means raising most of it from foreign investors, by selling them equity or subordinated debt. Or, indeed, entire banks.

This year Austria's Raiffeisen International Bank, which has been operating in Russia since 1996, paid $550m for Impexbank, a Russian bank specialising in retail banking and consumer finance. This deal gives Raiffeisen 190 new

branches across the country, plus 350 consumer-finance outlets in supermarkets and shopping centres. Nicholas Tesseyman, deputy director of the Moscow office of the European Bank for Reconstruction and Development, calls the Impex deal “the first significant acquisition by a foreign player in the banking sector...Up until now they have been tiny deals, acquisitions of shell banks or greenfield projects. This is something that may break the mould.”

Banks everywhere, and nothing to buy

Foreigners who want to buy a Russian bank may think that they have plenty from which to choose. The central bank recorded 1,199 licensed banks at the end of January 2006—one for every $550m of GDP, compared with one for every $1.4 billion in America. But that raw number is misleading. All but 100 or so of Russia's banks are tiny, or dormant, or are “pocket” institutions serving the needs of at most one or two controlling shareholders. Any self-respecting business group wants a licensed bank as its corporate treasury, because under Russian law it is much more tax-efficient for companies to lend or borrow money via a bank than directly.

Discard the dormant, the captive and the pocket banks, and the picture changes dramatically. There are very few banks in Russia serving a wide range of customers. The state-controlled savings bank, Sberbank, accounted for 26% of all the assets and liabilities in the country's banking system at the end of 2005, including 54% of all retail deposits. The second- and third-ranking banks, Vneshtorgbank and Gazprombank, are also state-controlled. Together with Sberbank, they accounted for about two-fifths of total assets. The four biggest privately owned Russian banks, Alfa Bank, MDM, Rosbank and UralSib, have about 8% of the market between them. There are 42 foreign-owned banks which between them have about 7% of the market, with Raiffeisen and Citibank the most visible. Most of the remaining top 100 are very small banks with regional or industrial niches, a handful of corporate customers and big ideas.

“Almost every Russian bank that you meet will tell you that its ambition is to be in the top 30 or 40 Russian banks, and to develop retail business, and to expand into the regions,” says Mr Tesseyman, who meets plenty of them. These are admirable aims, but clearly they are not going to be achievable by all banks. The alternative ambition—and perhaps the real aim of every private bank in Russia bar one or two—is to sell out to foreigners at a fancy price. Now that Impex has sold for almost three times book value, sellers of the bigger private banks are going to be arguing for four times or more.

How about a listing?

For larger private banks, fancy prices may also be available through the stockmarket. Sberbank has enjoyed a long run as the only listed Russian bank stock with any liquidity. Its shares have been much in demand, tripling last year (see chart 8). That left Sberbank trading at 20 times historic earnings this year, much higher than most commercial banks. Other Russian banks want to follow if the markets hold up. Analysts say that Rosbank may go this year, and that Vneshtorgbank and Gazprombank, both state-controlled, may list minority stakes next year.

Buyers will have to proceed with caution. Russian assets are no longer cheap, and Russian banks are moving targets. Loan portfolios are growing fast, but there are not nearly enough data to model the risks, and such few as are available have been collected during an economic boom. Credit quality may look very different when a downturn hits. At best, says Richard Hainsworth, who runs a bank credit-rating agency called RusRating, “we can look at the experience of other countries, we can make the assumption that the Russian population will behave in a similar way, but that assumption is tendentious, to say the least.”

Nor is the Russian government's behaviour all that easy to predict. In principle it welcomes free enterprise and foreign direct investors. In practice it hates any loss of administrative control over industries it considers of strategic value. One issue holding up Russia's bid to join the World Trade Organisation has been the government's refusal to ease restrictions on foreign bank branches.

Russia's protectionism would be more defensible if there were already so much scale and diversity and competition within the banking industry that the entry of more big foreign players would make little difference. But Russia is not even half way there. The financial system functions better than it used to, but not nearly well enough. There is no long-term rouble debt to speak of. Short-term lending rates are high. Many regional banks in effect have monopolies in local markets, thanks to official backing, the IMF said last year. Assets are highly concentrated on a few large borrowers and related lending is common, reflecting the structure of an economy where a handful of business groups represents close to half of GDP.

That concentration of ownership makes Russia a paradise for investment bankers chasing big-ticket clients: the country has perhaps 20 companies with a net income above $1 billion, against four or five in India. A proposed

share issue for a Russian state-owned oil company, Rosneft, could be the biggest ever initial public offering from an emerging market. International investment banks are racing to increase their presence in Russia. Late last year Deutsche Bank paid a reported $420m for 60% of UFG, a Moscow investment bank, after buying 40% in 2003. But for the commercial banks, concentration of ownership just makes life difficult. They very quickly get to their limits for any one borrower, at which point they have to stop lending or circumvent the law. If Russia had more big banks, the needs of its big companies would be better served and their risks more widely spread.

The financial system, like the rest of the economy, has become more robust since the shambles of 1998. There is far more money around. The government is rich. The administration runs more effectively. But a mini-panic swept some banks comparatively recently, in mid-2004, and it is not hard to imagine something on that scale being repeated. Two private banks suffered runs. One of them, Gutabank, suspended operations. A state-owned bank, Vneshtorgbank, subsequently took it over at a token price.

The 2004 panic was encouraged by a lack of public confidence in banking regulation and in banking stability. In a bid to allay fears about the second, the government began to introduce deposit insurance last year. But the insurance provision has not been accompanied by an obvious improvement in the quality of bank regulation, so the main result may be to increase the moral hazard both that banks will use their depositors' money rashly and that depositors will have less reason to choose strong banks over weak ones.

The best thing for Russia's banking system would be a break-up and privatisation of Sberbank, but the country's botched sales of industrial companies in the 1990s have made that option unthinkable. So, too, has Russia's political course. It has become a far more statist country since Vladimir Putin took power in 2000. If a sale of minority stakes in Vneshtorgbank and Gazprombank does indeed go ahead, it will suggest that Russia thinks market discipline can help raise the transparency and efficiency even of state-controlled banks. That is a good thing. The bad thing is that these state-owned banks look set to stay as top dogs of the banking system. If private and foreign banks somehow manage to eat substantially into the dominant positions of Sberbank, Vneshtorgbank and Gazprombank, the state, on present form, will help them bite back.

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High living

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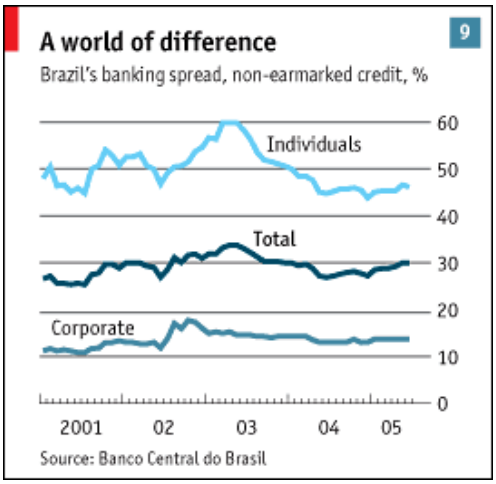
Brazil's banks charge startling rates to private customers



THE profit of $5.5 billion reais reported for 2005 by the biggest private bank in Brazil, Banco Bradesco, was the highest ever made by a Latin American bank. It implied a return on equity of 32%, making Bradesco twice as profitable as the average European or American commercial bank, and more profitable than a Wall Street investment bank in a good year. Bradesco's 80% growth in profits was all the more impressive in a year when the Brazilian economy grew by only 2.3%.

Bradesco attributed the good result mainly to cost control and loan growth. Loans to clients rose during 2005 from 34% to 39% of total assets, leaving less money parked in government securities.

But the leap in profits for Bradesco and other Brazilian banks will reinforce long-running grumbles in Brazil that banks there, as in many other Latin America countries, charge far too much for their loans, especially to private borrowers. Banks' net interest margins in the region are about half as high again as in the rest of the developing world. Many analysts have asked why, and drawn a blank from most of the usual suspects. Banks in Latin America do not differ markedly from those elsewhere in the developing world in terms of their size, or the volatility of their macroeconomic environment, or in the tax burden they bear.

Nor, in Brazil, is there an obvious lack of competition. Five banks share just over half the market, a similar ratio to that in much of western Europe. Yet some lending rates are eye-watering. A monthly survey of interest rates compiled by a Brazilian trade union, Anefac, found that the average monthly interest rate on a bank overdraft in February was 8.19%, equivalent to a compound annual rate of 157%. If you borrow on a credit card, you pay 10.24% a month or 222% a year.

Brazil has a history of high inflation, which used to mean that interest rates were vertiginous, and so were banks' margins. But inflation is supposed to be well under control now and might even drop below 5% this year. That made the central bank's benchmark interest rate of 15.75% in April no bargain, but no excuse for three-figure overdraft rates either. Are the banks colluding?

Joao Manoel Pinho de Mello, a professor at Pontifícia Universidade Católica in Rio de Janeiro, says it may look like collusion, but he suggests a market-based reason, adverse selection, as one reason why personal rates have stayed so high. Borrowers prone to default, he says, may be disproportionately sensitive to changes in interest rates. A bank will not rush to undercut its competitors if an offer of cheaper overdrafts merely brings it a larger share of deadbeat customers.

And, to be fair, there are cheaper ways for Brazilians to borrow. Workers can get much lower interest rates through employer-sponsored schemes, with repayments deducted from their wages. Borrowing of this sort has been increasing much faster than direct personal lending in recent years.

But even taking these cheaper loans into account, the banks' average spread on a personal loan earlier this year was 44%, about three times that on a corporate loan. If banks in Brazil are serious about building up their retail business, this needs to come down.

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Naturally gifted

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Overprotected it may be, but India's banking sector is going from strength to strength

WHATEVER it takes to be good at banking, India has it by the bucketload at every level. Look at the number of Indian expatriates holding down whizz-kid jobs at investment banks in London and New York, at least until they are lured back by investment banks in India itself. Look at the growing proportion of back-office work that foreign banks are moving to India by offshoring and outsourcing. It is not only the basic payments and call-centre chores that get moved to India these days. Late last year JPMorgan Chase said it planned to move one-third of the processing of its foreign-exchange trades and of its credit derivative contracts, having already moved some of its financial research and analysis. By 2007 it expects to have 9,000 employees in India, up from 5,000 now, one-quarter of them working for its investment-banking division. Deutsche Bank, UBS and others are making similar moves.

Look, too, at the bold growth strategies of the new private banks that have flourished since India began relaxing the state's near-monopoly on the banking system in 1992. They have munched into the market share of the remaining state-owned banks, as you would expect. Less predictably, they have nibbled away at the market share of foreign banks too—partly because the foreigners have been more tightly regulated, but also because the new Indian banks have been dauntingly good at selling themselves and at keeping down their costs. The biggest of them, ICICI Bank, managed a return on assets and a profit per employee last year almost identical with that of Standard Chartered, the biggest of the foreign banks. At the same time, its deposit base, and its loan portfolio, grew much faster.

The foreign banks have every right to feel mildly annoyed with the Indian government, which has kept them on a leash much shorter than that of their Indian competitors. For all the reform and deregulation across much of the Indian economy since the financial crisis of 1990-91, the government still has no plans to let foreigners buy Indian banks (except as distress sales) until at least 2009, and there is no certainty that it will happen even then. In the meantime the 31 foreign banks active in the market are guaranteed the right to open no more than 12 branches a year between them.

The foreigners have been consoled by the formidable growth of the banking market as whole. Total assets have doubled in the past five years. Consumer lending alone has been growing by an average of 40% in each of the past five years, enough to keep the foreign banks' assets and profits growing handsomely despite a slight loss of market share.

By restricting the expansion of foreign banks, and so limiting the competition to provide banking services to Indian customers, the government has kept business costs unnecessarily high. Even so, to judge from the development of the banking sector, this is one of those rare occasions when it is tempting to claim that a touch of protectionism has had its benefits. It gave the Indian private banks the space to learn how to grow, and to gain confidence as they went. The biggest of them, ICICI and HDFC, burst forth with mass-market low-cost national business models

that pitted them directly against the big state-owned banks, perhaps forcing competition on them more effectively than any foreign banks might have done.

The wonders of competition

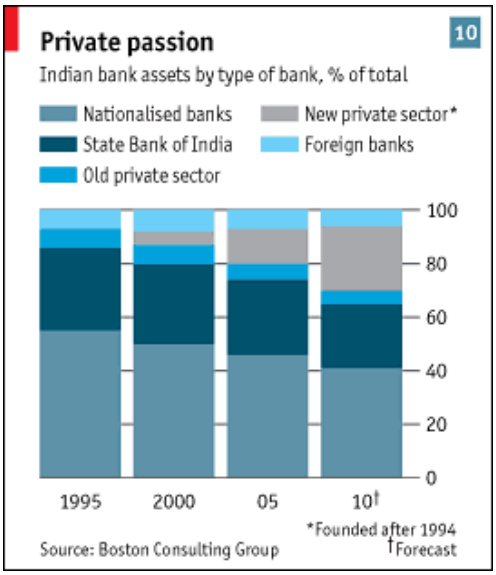
As a result, “competition induced by the new private-sector banks has clearly re-energised the Indian banking sector as a whole,” in the words of Rakesh Mohan, deputy governor of the Reserve Bank of India, the central bank. In the five years to 2004, operating costs at India's public-sector banks fell from 66% to 45% of revenues. Return on assets, a measure of profitability, rose from 0.57% to 0.89%. Non-performing loans fell from 14% of the loan book to 5.5%. All this was done with a relatively modest contribution of state funds, less than 1% of GDP in all, to recapitalise the public-sector banks, offset by investment gains, as minority stakes in public-sector banks were sold on the stockmarket and the shares rose in value.

As in so much of Asia, the fastest growth was in consumer lending. That will remain one of the most buoyant markets in India, thanks to favourable demographics, changing cultural and consumption patterns, higher purchasing power and the spread of financial services outside the big cities. Fitch Ratings calculates that retail lending as a share of all bank lending in India has risen from 11% to 24% in the past five years. But relative to GDP it remains fairly low by world standards, at 10%, against 13% in China, 50-60% in smaller Asian economies such as Malaysia and Singapore, and 80-100% in rich countries such as Britain and America.

One big winner from the growth of retail lending has been ICICI Bank, the biggest of the new private banks. Founded as a state development bank in 1955, it formed a commercial banking subsidiary in 1994. The development and the commercial bank made separate offerings of their shares, then merged again in 2002. Retail banking currently accounts for about two-thirds of the balance sheet. “We were the first to identify the changes in the economy, we could ride the curve,” says Vishakha Mulye, ICICI Bank's chief financial officer.

In the past four years, ICICI Bank has also been busy expanding internationally. It has branches or subsidiaries in 12 countries, aiming its services mainly at Indian communities overseas but sometimes finding that they attract a much wider clientele. Last year ICICI Bank launched a direct-banking service in Britain, offering a deposit rate half a percentage point above that of its main rivals, which the bank said was made possible by the low cost of operating the service from India. Demand was so strong that it swamped ICICI Bank's computers.

Hard on ICICI Bank's heels comes HDFC Bank, India's second-largest private bank, which was spun off from a government-owned mortgage institution of the same name in 1994. HDFC Bank thinks of itself as being a touch more selective than ICICI Bank. “When the market is growing, you can say, ‘I will grab market share and I will figure out along the way how to make money from it,' or you can say, ‘I can pick and choose, and still grow,' and we have opted for the second,” says Paresh Sukthankar, HDFC Bank's country head of credit and market risk. HDFC reported net non-performing loans equal to just 0.24% of the loan book in its last published balance sheet, against 1.65% for ICICI Bank and 3.84% for the banking system as a whole. But those are low figures for fast-growing banks, all the more so in a banking system where three-quarters of the assets are still in the hands of government-controlled institutions that are vulnerable to inefficiency and political interference. However good Indian bankers are at their jobs, their loan books could still show up some nasty surprises if and when the economy turns down.



A perfect moment for reform

For the moment the economy is buoyant, to the point at which India has displaced even China as the favourite big story among foreign investors. Now would be a perfect moment for the government to push India's banking reforms further, by selling down state shareholdings and by encouraging further consolidation. The banking system would evolve from a large number of small banks to a small number of large banks. A first step in that direction would be some arranged mergers among the country's 28 public-sector banks, ending up with three or four banks big enough to thrive independently or to fetch a fancy price from Indian or foreign buyers.

The main opposition to further consolidation even along these lines comes from India's trade unions and their political allies who fear that it would cause job losses. But much of that fear may be misplaced, says Janmejaya Sinha, a vice-president of Boston Consulting Group, at least as regards branch closures. The problem in India is one of too few bank branches, not too many, especially outside the big cities.

With a stable of big, strong domestic banks, India could be much more relaxed about lowering the remaining barriers to foreign entry. That would benefit the economy through increased competition. It would also be good for Indian banks, or at least for those that rose to the challenge. It would let them prove to themselves that they are every bit as good as the best foreign competition, and they would be less likely to be denied market entry by other countries on reciprocity grounds. The stage would then be set for decades of growth in which Indian banks would become powerful players, first in other Asian markets and then across the world.

That may sound far-fetched. But as basic banking becomes more of a commodity business, the winners will be the banks that can do it most cheaply. India has the necessary skills at the keenest prices. Foreign banks can move only so many of their operations there, but Indian banks have all of them there already, at costs far below their developed-country rivals'.

If Indian banks want to expand overseas, they still have to resolve the reputation issue. Customers in Europe or America might hesitate to rely on a bank (and a banking regulator) in Mumbai to preserve their savings. But such things can change. After all, Western consumers once mocked the idea of Japan as a carmaker, yet Japan soon proved them wrong. India might pull off the same trick in financial services. But first its government has to get out of the way and give the bankers a chance.

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Proceed with caution

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Financial services in China are set for huge growth, but there is no easy way in

BIGGER may sometimes be better in banking, but ownership matters too. Whatever the size of a bank, it will usually perform worse in government hands, because governments are generally less motivated than private shareholders are, and less good than market forces are at collecting and digesting information. Besides, they have lots of other things to do. There are bound to be conflicts of interest and lapses of concentration. The bigger the state-owned bank, the bigger the mistakes it is liable to make.

Piling in 11

Top ten recent foreign investments in Chinese banks

Date	Target *(% purchased)*	Acquirer *(nationality)*	Deal value $m
Aug 2005	Bank of China *(10.0)*	Royal Bank of Scotland *(Britain)*, Merrill Lynch *(US)*, Li Ka-shing *(Hong Kong)*	3,100
Jun 2005	China Construction Bank Corp *(9.0)*	Bank of America *(US)*	3,000
Dec 2005	Guangdong Development Bank* *(85.0)*	Citigroup *(US)* and others	3,000
Jan 2006	Industrial & Commercial Bank of China *(7.0)*	Goldman Sachs *(US)*	2,580
Jun 2005	China Construction Bank Corp *(5.1)*	Temasek Holdings *(Singapore)*	2,466
Aug 2004	Bank of Communications *(19.9)*	HSBC Holdings *(Britain)*	1,745
Sep 2005	Bank of China *(5.0)*	Temasek Holdings *(Singapore)*	1,550
Jan 2006	Industrial & Commercial Bank of China *(2.5)*	Allianz *(Germany)*	1,000
Mar 2006	China CITIC Bank *(19.9)*	CITIC *(Hong Kong)*	714
Sep 2005	Bank of China *(1.6)*	UBS *(Switzerland)*	500

Source: Dealogic *Subject to regulatory approval

China has paid dearly for the mistakes of four big new commercial banks which the government carved out of the old communist banking system in 1994-95. Bewildered by the rush to capitalism, the big state banks were soon making two bad loans for every three good ones. The government set about cleaning them up in earnest in 1999, taking loans equivalent to 17% of GDP off their books.

When that failed to change the banks' ways, the government was forced to take a new and more radical tack. In 2003 it said it would recapitalise two of the four, the Bank of China (BOC) and the China Construction Bank (CCB), using $45 billion from state reserves. Then it would bring in outside investors, who might know how to change the banks in ways that the government did not, and it would float minority stakes in the banks on the Hong Kong stockmarket, in the hope that market discipline could also play its part.

Last year a similar plan was announced for a third bank, the Industrial and Commercial Bank of China (ICBC). This restructuring may cost up to $80 billion, says Richard Podpiera, an economist with the International Monetary Fund. Last to come will be a clean-up at the fourth bank, the Agricultural Bank of China, which is said to have the lowest credit quality, the least efficient operations and the lowest degree of transparency of any of the four. The bill there may be the highest of the lot.

Early birds

If China's banks had dug themselves into some scarily deep holes, foreign investors proved remarkably keen to jump in alongside them and help them dig their way out again. From the moment the government began talking of selling stakes in CCB and BOC, a queue of foreigners formed to buy. The same happened when it added ICBC to the list in 2005.

So far China has collected more than $20 billion for stakes in banks some of which would have been unsellable at any price seven years earlier. These were big and risky investments by anybody's standards, but in some ways they have started to look like bargains already. The government began by selling shares to direct investors at about 1.2 times book value. When 12% of CCB was floated in Hong Kong last year, investors on the stockmarket

were willing to pay almost twice book value. That implied big paper gains for the direct investors in CCB and left some in China grumbling that the banks had been sold too cheaply.

Not so. It was the arrival of direct investors that raised the perceived value of the banks. The foreigners were expected to improve the management and the corporate governance of the banks to the benefit of all shareholders. The readiness of big institutions to risk their capital was taken as a sign that there were no more huge horrors left lurking in the banks' loan portfolios. Their presence was essential to getting the public listings moving at all.

As for the foreigners, they have got a foothold in a huge market just as the conventional wisdom has been shifting in its favour. For any financial institution with global pretensions, the perceived risk no longer lies with getting into China, it lies with daring to stay out.

The calculations on both sides may have worked out well in the short term, but that leaves two big questions open for the long term. The first is whether the current optimism about future growth in Chinese financial services is well founded. The second is whether, even in a growth market, these big state banks are the best choice for foreign investors.

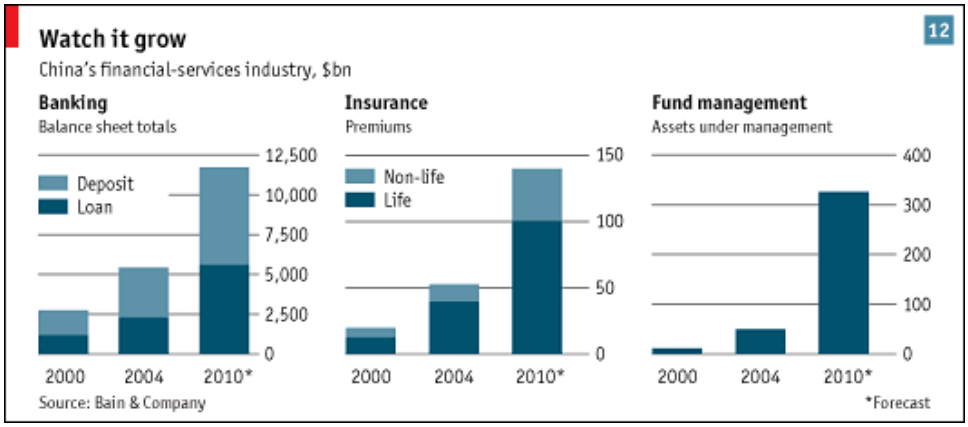
On the first of those points, the answer is a “yes” that gets more confident the longer the view that you take. Goldman Sachs forecasts that the number of people in China with incomes over $3,000 a year will rise tenfold between 2005 and 2015. China's government, though it has proved itself capable of huge policy errors in the past, is getting steadily more confident about allowing market forces to help shape the economy, including, at long last, the financial-services sector. If things go tolerably well, say the consultants at Bain, total banking assets in China in 2010 will be twice what they were in 2004. The market for insurance will almost triple, and assets under management will increase sixfold (see chart 12).

There could be hiccups, or worse, along the way, however. David Marshall, regional head of financial institutions for Fitch Ratings, says that a sharp slowdown in China's economic growth could lead to losses of 10% of bank loan books. A serious recession could well mean a banking crisis in which credit losses overwhelmed the banks' still-slender capital bases.

The downside risk

As to whether the big state banks offer the best way for foreign banks to capture this formidable growth, the evidence is more equivocal. The biggest contra-indicator is that HSBC and Citigroup, two big foreign banks which know China well and which have huge experience of building up foreign operations, have chosen other routes into the market.

Citigroup paid $70m for a 4.6% stake in China's eighth-biggest bank, Shanghai Pudong Development Bank, in 2002. It is now in the process of raising that stake to 19.9%. It is also leading a consortium of foreigners offering to pay $3 billion for 85% of Guangdong Development Bank, another medium-sized bank from China's prosperous south, a deal that will require China's leaders to waive their rule that foreigners cannot own more than 25% of any bank.



HSBC has also chosen to put its eggs in smaller baskets. In 2004 it paid $1.75 billion for a 19.9% share in Bank of Communications (BoCom), which is China's fifth-biggest bank but which has only one-eighth the number of branches and staff of ICBC, the biggest state bank. In addition, HSBC is building up a branch network that currently stretches to 12 main branches and eight sub-branches. It also has stakes in a municipal bank, the Bank of Shanghai, and in an insurance company, Ping An.

If HSBC, one of the world's biggest banks, with all the advantages that its Chinese roots bring it in terms of geography, language and culture, sees BoCom as the right size of partner, are other foreign investors over-reaching themselves by pairing up with banks five times BoCom's size?

The short answer is that the foreigners will probably not have a huge impact on the state banks, whatever the early buzz. At most they can seed the Chinese banks with a few good ideas and a few good people, and hope that these take root and flourish. They can also make a fuss if they see things going badly wrong inside the banks. And that may be enough for them. After all, they want other things out of the relationship too.

They get access to the state banks' huge branch networks as distribution channels for their products. They can guide the development of narrow but profitable lines of new business such as credit cards. They get, or so they hope, a closer relationship with the government that will help them obtain other licences in the future, for example in insurance and in brokerage. So any further capital gain on their investment will be a bonus.

The state banks, in short, may never get much better at their basic business of borrowing and lending than they are already, which is to say, not much good at all. That matters less as long as a rising tide of growth and modernisation in China is lifting all ships. But with a 60% market share, six layers of management between head office and branch level, huge staff numbers and very little experience of lending on strict commercial criteria, the state banks will find it hard to grow, let alone to modernise, as fast as their smaller rivals.

When the capital markets wake up

They are already losing good business to smaller joint-stock banks. They will lose more good business when (and if) China eases its restrictions on foreign banks by next year, in line with its commitments to the World Trade Organisation. And they will lose more business still when China at last gets round to modernising and opening up its capital markets. The lack of development in this area in the past decade has left the banking sector with a near-monopoly on corporate lending. Banking assets are very high by international standards, at 210% of GDP in 2004. More competition is needed from the capital markets if China wants to build a modern market economy.

The capital markets need time and money to get on their feet, just as the banking sector did. The majority of China's 130 or so securities companies were left technically insolvent after a decade of ill-managed speculation. But the capital markets' turn must come. When they start to attract money away from the banks, what now looks like a high-growth, high-margin banking industry will look much more like low-growth and low-margin, at least for average and below-average performers. So the strategic investors who paid 1.2 times book value to get into the big and slow-moving state banks probably got the price about right. Later buyers, beware.

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Back in business

May 18th 2006
From The Economist print edition

Japan's banks have restructured and consolidated. Now they must find new ways of making money

FOR a society so given to miniaturism, Japan is powerfully attached to gigantism in banking. In a study of the banking crisis and economic slump that gutted Japan in the 1990s, Akihiro Kanaya and David Woo, economists with the International Monetary Fund, say that part of the cause was the “persistent focus of banks on market share”. The banks pursued growth for growth's sake, making new loans at the peak of property and stockmarket bubbles in 1989-90 when that meant taking on riskier and riskier customers at lower and lower margins.

When those loans went bad, the weakest banks collapsed, but only after they had made another lot of bad loans in the hope of growing their way out of trouble, postponing a banking recovery by another half-decade. From a high point in 1986, when they accounted for a quarter of the Japanese stockmarket's capitalisation, to a low point in 2003, when they spoke for less than 3% of it, the banks have had a gruelling ride. Their lending contracted by one-third, and familiar names disappeared in a wave of mergers and bail-outs. Eleven of the country's biggest commercial and development banks, some of them among the largest in the world, consolidated into three “megabanks”.

Industrial Bank of Japan, Dai-Ichi Kangyo Bank and Fuji Bank were among the big names subsumed into Mizuho in 2000; Sumitomo Bank and Sakura Bank fused into Sumitomo Mitsui in 2001; and in January this year Bank of Tokyo-Mitsubishi and UFJ, both the product of earlier mergers, completed a merger which once again gave Japan the biggest bank in the world by total assets: Mitsubishi-UFJ Financial Group, or MUFG, with a balance-sheet total of $1.7 trillion, slightly more than that of America's Citigroup.

That has made MUFG cock of the walk, ahead of Mizuho with $1.46 trillion in total assets and Sumitomo Mitsui Financial Group with $900 billion. These banks are even bigger than the biggest banks of the pre-crisis days. But are they any better?

The stockmarket certainly seems pretty keen on them. Bank shares have multiplied in value since the low point struck three years ago. But the big banks' profitability remains low by international standards, and their strategic direction is unclear. They are run by a generation of managers who got where they are today by managing shrinkage, not growth.

Not only do the banks have to grow again, they have to grow in new directions if they want to boost their profits to international standards. They now have to do well as retail banks, a line of business in which they have been relatively weak but which is the least volatile and most profitable area of banking in most rich countries. Whereas HSBC gets more than 60% of its profits from retail banking and Citigroup more than 70%, the figure for Mizuho is about 42%, for SMFG 15% and for MUFG 16%, says Naoko Nemoto, an analyst with Standard & Poor's.

The blockage in Japan looks like one of supply, not demand. David Atkinson, an analyst with Goldman Sachs in Tokyo, calculates that the big banks have only 2,700 branches between them in the whole of Japan. One carmaker alone, Toyota, has almost twice as many dealerships. Divide the sales staff of Japan's major banks by the customer base, says Mr Atkinson, and there are only enough staff for at most 55 minutes of personal contact with each customer each year, allowing for about two transactions of modest complexity. By contrast, the average customer of an American retail bank expects to conduct two or three branch transactions per month.

Newer, nimbler banks have been seizing the opportunity. They include Shinsei Bank, re-born from the Long Term Credit Bank of Japan, which collapsed in 1998 and was bought two years later by foreign investors. Its retail banking business has attracted 1.6m customers from a standing start in 2001. A survey by the *Nihon Keizai*

Shimbun newspaper ranked Shinsei the best bank in Japan for customer service last year, followed by Sony Bank, an internet bank launched by the Sony group five years ago.

The biggest network of them all

The big Japanese banks had even less incentive to develop retail networks while the state-owned post office savings bank offered a cheap alternative. But the savings bank, by some measures the biggest financial institution in the world, is now due to be privatised. Its long-term future is not yet clear (see article). It scarcely matters, however, whether Japan's big banks expect the privatised postal savings bank to be a Godzilla-sized competitor in 12 years' time, or whether they foresee its dwindling from a major to a minor competitor. Either possibility ought to be focusing their minds on the need to strengthen their own retail business. So too should the prospect of rising short-term interest rates, after years of zero rates. Even allowing for a rise in deposit rates as well, banks should be able to get a better return from loans than they have been doing in recent years.

There are signs that the big Japanese banks have indeed been looking ahead to such things. Moving, as often, in convoy, they have been buying into finance companies which operate credit cards and which lend money at high interest rates to people with poor credit histories. This may yield some short-term profits, but the banks would be eccentric to put too much long-term emphasis on this limited market when they have so many better-heeled customers of their own to whom they could be selling loans. Very probably they have that in mind, and they are buying finance companies to help them understand better how the process works. Fine, though they might acquire the same knowledge more cheaply by hiring a consulting firm or buying a book.

Building up a branch network can be an expensive and time-consuming process. Mr Atkinson thinks that in the long term MUFG could reasonably aim for 1,500 branches, or two-thirds more than it has at present. It sounds a lot, but what other option does MUFG have? It has huge assets but relatively low profits. If it wants to be valued in the stockmarket at anything like the size of its global rivals, retail expansion is the only large-scale option readily available to it, and to its rivals too.

And perhaps then, with more proven retail expertise at home, Japanese banks will become a touch more visible abroad, where after the retrenchment of the past decade they are at present hardly visible at all. Which is not to say they are entirely absent, but that their business is mainly in financing Japanese investments and Japan-related trade. As India's economy boomed last year, lending there by Japanese banks tripled to $4.3 billion. But China in particular must present a frustrating spectacle. Its banking system has opened to foreign investment, the potential is immense, Western banks are piling in—yet Japanese banks are standing on the sidelines.

The timing has been bad for them, because they mostly still need to repay money which the government lent them during the banking crisis. Until they have finished doing that, they can hardly start throwing money around elsewhere. The politics are touchy, too. Japan's pre-1945 empire casts a long shadow. Relations with China have become more fractious during Junichiro Koizumi's term as prime minister, partly because his visits to the Yasukuni war shrine in Tokyo have caused angry protests in China, and partly because Japan is seen as an ally of China's great new rival, America.

Even if the political climate improves and when Japan's banks have paid off the government, they need to have a banking model worth exporting, whether to China or anywhere else. Such things can be built from unlikely beginnings. Think how useless British banks were at retail in the 1960s, and how much better they are now. Japan has formidable traditions of mass production and of personal service. Put them together, and a great retail banking system could be built on that foundation—equal to the corporate banking system of which the Japanese were justly proud for most of the 20th century.

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A funny sort of privatisation

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The future of Japan's postal savings bank remains a mystery

SMALL savers across Japan can hunt down a bank branch, or they can let the postman come to them, collect their money and put it in the postal savings bank. Until next year they also have the benefit of an unconditional government guarantee on deposits. During the banking crisis of the 1990s savers shifted their money to Japan Post en masse, causing its deposits to double.

Now the commercial banks are back to normal, and the government is moving to privatise the postal savings bank. But nobody knows yet whether this will create a giant new competitor for the banks, or whether it will give them new markets to cannibalise.

In broad economic terms, the postal savings bank has done Japan questionable good. It was a safe harbour for savers in the 1990s and so perhaps averted an even bigger panic. But if it had not been there, perhaps the Japanese banks would have got into retail banking earlier and diversified their business, making their lending less concentrated and the crash less severe. The postal savings bank has also served the state as a captive buyer of government bonds and as a direct cash-cow for other government agencies and programmes, keeping some spending out of the hands of the parliament and making the government budget for each year look much better than it was.

A step in the right direction

A first partial reform in 2001 ended the direct use of the postal savings system for policy lending by the government. But the savings bank remained a very big buyer of Japanese government bonds, holding about 30% of the entire stock, and of bonds issued by the same government agencies which the savings bank used to fund directly. All the same, the process has introduced more transparency and discipline, and has helped to prepare the way for further reform: the privatisation of the whole post office, which is due to begin next year.

The four main components of the post office will be put into separate companies: the savings bank; a life-insurance business; the network of 25,000 post-office branches; and the mail-delivery system. But they will remain under a single state holding company until 2017. Then, as the law currently stands, the government will have to divest itself entirely of the savings bank and the insurance business, though there is nothing to stop it repurchasing them immediately if it has changed its mind about the sale by then.

If that sounds a funny sort of privatisation, it is all the funnier because seemingly nobody, unless this is a very well-kept official secret, knows how the savings bank is going to operate from 2007 onwards, even while it is still under state management. It could be left to dwindle as a minimum service for people with no alternative, or it could be managed energetically as a rival to the banks. The only thing on which there is general agreement is that nothing should be done to frighten away depositors. If they pulled out their money in a rush, that would force the savings bank to raise money by selling securities, including its huge government bond positions, sending the bond markets crashing.

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The limits to size

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When banks go wrong, the biggest come off worst. But that doesn't stop the scramble for growth

TO SAY that bankers are getting better at banking is to say that they are getting better at information technology, and higher mathematics, and retailing, and marketing, as well as at hiring and managing people who are specialists in those things. Risk management, the rock on which any contemporary bank rests, scarcely existed as a profession outside the insurance industry until the 1970s.

The ruthless scrutiny of capital markets and regulators has been good for banking but hard on bankers. It means that the modern banker, even (and especially) the biggest boss of the biggest bank, must be a details man. The bank is a vast machine, and he is its chief engineer.

Ken Lewis, boss of Bank of America, downplays even his importance as a strategist. The things that make Bank of America special, he says, are “franchise”, or market position; “execution”, or operational efficiency; and track record. Beyond that, he told an investor conference in February, “we believe strongly that there are no unique strategies in financial services.”

Nor unique products, to judge from a letter to shareholders written earlier this year by James Dimon, JPMorgan Chase's boss. The bank's job was to deliver the right bundle of products at the right price, he said. “Where the products are ‘manufactured' is of little interest” to customers, he said. That is a fair claim to make so long as the product proves reliable. If it goes even a tiny bit wrong, then where and how it is manufactured suddenly starts to matter very much indeed.

This survey began by asking whether, as banks grew and as banking systems consolidated, there was a natural limit to their size. The short answer is that no bank can be too big, so long as there is enough free competition to keep it on its toes. If banks are right about economies of scale, and if management and information systems can keep pace, then why should banks not go on consolidating until only three or four or five of them are left, with three-quarters of the market between them, in a given country, or a given continent, or indeed the world?

The problem is that banks do go wrong from time to time, and whenever that happens, size turns out to be their worst feature. The bigger a troubled bank, the less credible a government's claim that it will not intervene, the harder to manage the failure, and the bigger the final bill to taxpayers. Even without a crisis, a bank is getting too big for comfort if regulators start making their rules around it. That stifles new competition and provides room for risk to grow. So even if economies of scale were infinite, bigger banks would not always be better banks.

One answer might be for countries to cap the size of any bank as a share of GDP. The figure would differ from country to country, depending on the appetite for public spending, the place of financial services in the economy and the desire to accommodate national champions. The cap for America might be 1% of GDP for any one bank's capital, beyond which it might grow organically but not by acquisition. That would be no more intrusive than the current American rule stopping any one bank gaining more than a 10% market share of deposits by acquisition, a limit already touched by Bank of America.

But that last factor aside, there is no obvious limit to consolidation currently in sight, only supply and demand. In February Charles Prince, Citigroup's chairman, offered his view of the future: “Nobody wants to sell. Everybody wants to buy something. Any bank holding company of size is in the acquisition mode, not the selling mode. It's just as simple as that.”

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Time Warner and AOL

From :-) to :-(

May 18th 2006 | NEW YORK
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Once the darling of the internet, AOL is struggling to remain relevant

Get article background

FEW people at Time Warner, the biggest media company in the world, have anything nice to say about AOL, its internet division. Executives who had shares in Time Warner at the time of its merger with AOL in 2000 find it hard to forget how their savings were wiped out in the aftermath—the company's share price fell by 75%—and how arrogant the AOL people used to be. Five years on from the merger, AOL is still the sick man among Time Warner's television, film and publishing businesses, and it is as unloved as ever.

Time Warner may soon have to decide whether to push the patient out of the door. It is certainly under no illusions about AOL's prospects, nor is it particularly attached to the business. The firm is already looking into a possible sale of parts of AOL Europe. “For the moment, the doctor says more tests are needed,” says Larry Haverty, a fund manager at Gabelli Global Multimedia Trust. By the autumn, he argues, it will be clearer whether Time Warner should sell AOL.

In the 1990s, during the early days of the internet, AOL flourished by sitting at the juncture of three online businesses: advertising, access (as an online-service provider with monthly subscribers) and e-commerce (through its affiliated merchants). But today's internet users have no need to pay AOL extra for its services, because they can go direct to other companies. And AOL failed to recognise early enough that people would move to broadband-internet access, which they can buy straight from the firms that own the network, whether a telephone company or a cable firm. Every year AOL loses a few million of the more than 20m people in America and Europe who pay it for dial-up internet access (see chart). In the first quarter its revenues dropped by 7% to $2 billion and its operating profits shrunk by 17%, to $442m, dragging down its parent's results.

AOL's response is to try to increase its revenues from internet advertising. To attract traffic, last year it flung open the doors to its collection of online “content” to every surfer; until then much of it had been available only to subscribers. Most analysts think this strategy is a good one. But investors are impatient to see gains from the advertising business offset the decline of the access side. That may never happen—and if it does, it could take many years. AOL's poor performance is particularly

sensitive at the moment because Time Warner's chief executive, Richard Parsons, recently saw off an attack from Carl Icahn, an activist investor. The conglomerate's share price (Mr Icahn's chief complaint) has not gone up since then, and analysts on Wall Street cite AOL as the main reason why they do not advise their clients to buy Time Warner's shares.

One of AOL's biggest problems, competitors say, is recruiting the best people in the technology industry and keeping them. Being based in Dulles, Virginia, away from the technology industry's centres, is hardly a draw. Moreover, AOL offers employees less chance to become rich through share options or an initial public offering than other internet firms that are growing. In contrast to its big rivals, which are hiring, AOL laid off 7% of its workforce this month. Several senior managers are rumoured soon to be leaving.

In search of superspice

When he was fighting off Mr Icahn, Mr Parsons called AOL the “internet superspice” of Time Warner. This positive view was bolstered last year when Google took a 5% stake in the business for $1 billion, although the internet giant was motivated less by AOL's attractions than by a desire to stop it allying with Microsoft, an arch-rival. AOL has had some notable successes in its new advertising strategy: last year, for instance, millions of people watched the Live 8 music concert on AOL.com, and AOL made a profit from the event by selling ads around it.

However, AOL's fortunes in advertising are worryingly dependent on its declining access business. AOL estimates that just over half of its unique monthly visitors are subscribers, rather than surfers with no other connection to the firm. So as subscribers leave, AOL will steadily lose page views. Moreover, each subscriber generates about six times as many page views as non-subscribers, says Henry Blodget, president of Cherry Hill Research, because subscriptions represent households rather than individuals, and because AOL members are heavy internet users. AOL has to swim against a strong tide to keep its position in internet advertising.

Better news is that the company is at least managing to maintain its page views, despite losing subscribers. But its rivals in internet advertising are rapidly increasing their page views and AOL will need to add page views if it is to grow in future. As for its total sales of advertising, which increased by 26% in the first quarter to $392m (or a fifth of total revenues), Mr Haverty says that the performance was acceptable, but unexciting compared with Yahoo!, which increased its advertising revenues by 35% from a much bigger base.

During recent years of innovation on the internet, as Google has risen to prominence and other popular new services such as Craigslist, MySpace and iTunes have taken wing, AOL has been distracted by its troubled relations with Time Warner—it was only last year that Steve Case, AOL's controversial co-founder, finally left the conglomerate's board. “AOL largely sat on the sidelines as the internet evolved over the past six years,” says Kevin Werbach of the University of Pennsylvania's Wharton School. Now, however, AOL is at last busy launching new services. This week it started a VOIP phone service based on its popular instant-messaging system, and earlier in May it launched a new social-networking service called AIM Pages. AOL has lots of experience in social networking, says Mr Werbach, and it has a good chance of succeeding even against well established competitors such as MySpace, which is owned by Rupert Murdoch's News Corporation.

Although AOL is having some success in attracting people to its content, the unit is not making good enough use of its parent's wide array of brands. People in Time Warner's other divisions complain that AOL develops new sites on its own and ignores them: AOL Sports, for instance, makes no use of the powerful *Sports Illustrated* brand, and its new celebrity site, TMZ.com, does not use material from Time Inc's *People* magazine and websites. Time Warner's divisions are mostly developing digital strategies independently of AOL.

For the moment, Time Warner's plan is to do as much as it can to encourage AOL's renewal. “In order to move AOL to an advertising business more rapidly,” says Jeff Bewkes, the firm's chief operating officer, “we may ourselves take actions so that AOL will rely less on subscriber volume or subscriber payments.” In other words, let paying users leave, as long as new traffic comes—a risky strategy, since so much traffic comes from the subscribers. In the end, the interdependence of the access and the advertising sides of AOL may lead Time Warner to sell the whole business—and put its painful past finally behind it.

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The paper industry

Trouble at mill

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Investors and the environment

ACROSS the Far East, Latin America and Central Europe, new pulp mills are springing up and existing mills are being extended. But these projects may carry a much bigger financial risk than investors have realised. Many schemes have exaggerated how much timber they can fell and crack downs on illegal logging threaten to make their new mills unprofitable.

Pulp mills are expensive. Building even a modest one from scratch can cost more than $1 billion. Small pulp mills tend to be financed by banks in their home markets. But the biggest projects, designed to produce more than 200,000 tonnes of pulp a year, generally seek funds from overseas. Over the past decade investment banks have invested some $40 billion in pulp mills, as demand for paper has soared. Some industry analysts foresee over $50 billion in new investment by 2015, much of it in Brazil, China and Indonesia.

The Centre for International Forestry Research, which is based in Indonesia, has just issued a new report on logging, which was paid for by the European Commission and Britain's Department for International Development. It examined 67 projects proposed between 1995 and 2003—just under half of them in Asia. The report argues that at least 20% of the projects had no proper environmental assessments. It is hardly surprising that a green lobby group should decry the practices of the logging industry. But what is new is that the report's author, Machteld Spek, a financial analyst, argues convincingly that a disregard for the sustainability of wood supplies and changing attitudes to logging, has exposed investors to considerable financial risk.

In Indonesia two pulp-mill companies, Asia Pulp & Paper and Asia Pacific Resources International, borrowed more than $15 billion in the 1990s from international capital markets, after convincing investors that they had sustainable supplies of cheap fibre for pulp. But both companies are still years away from planting enough trees to operate sustainably; and a recent crackdown on illegal logging in Indonesia promises to make their business even more difficult.

On the other side of the world Uruguay and Argentina are feuding over two pulp mills being built in Uruguay. The dispute has led to the blockade of a bridge between the two countries, and a halt to construction work on the mills. Argentina alleges that the mills will pollute the river on which they are being built, over which the two countries share sovereignty. Supporters of the mill argue that the Argentine government has taken no action against its own older, dirtier pulp mills, and argue that much of the opposition is driven by anti-capitalist militants. But David Kaimowitz, head of the Centre for International Forestry Research, says that the original environmental assessments failed to show that the mills will have enough wood from sustainable sources. He argues that private and public investors are going to have to be much more demanding with future projects.

The International Finance Corporation, the investment arm of the World Bank, is trying to tackle these problems by enforcing the “Equator Principles”. These allow lenders to sort projects into low, medium or high risk, and to demand environmental and social assessments accordingly. So far, more than 40 big banks have agreed to adopt them. A better grasp of environmental risk will help ensure that wood, and not investors' money, gets pulped.

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Indian airlines

In a state

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Can India's nationalised airlines be revived?

MERGE two problem-ridden government-owned airlines and create one thriving business. That seems to be the optimistic logic behind a government plan—after 20 years of indecision—to merge Air India, an international carrier, and Indian (formerly Indian Airlines), which flies mainly domestic routes. Praful Patel, India's ever-optimistic minister of civil aviation, says the merger will be done “this fiscal year”, but few officials or observers believe him. They see his statement as an attempt to get things going, rather than setting a deadline.

Formed more than 50 years ago, both airlines are long-past their prime. They have been dragged down by interfering politicians, ineffective managers, powerful unions, and an inability to expand because of a failure to invest in aircraft.

The state-run airlines look all the shoddier these days because of the rise of popular new private-sector carriers like Jet Airways. Indian had a domestic monopoly until privately owned airlines were allowed in the early 1990s. It now has a mere 23% of the domestic market, compared with Jet's 32% share, which will rise to 43% when it completes a takeover of Air Sahara. Air India now carries only 19% of air passengers going abroad.

In an effort to rescue the situation, the government has at last agreed to the state-owned airlines' buying new aircraft—they have ordered a total of 111 in recent months and will start transforming their aircraft fleets later this year. Profits have also been improving: Air India notched up $22m in 2004-05, while Indian managed $15m that year and expects a small improvement in 2005-06.

On their own, however, the two airlines lack the scale to take on an airline the size of Jet. Neither has been able to gain membership of the international airline alliances that would bring in foreign passengers. A lack of co-ordination also prevents Indian's passengers feeding into the flights of Air India. “There is increasing pressure on both airlines,” says Mr Patel—hence the urgent push for a merger. But in other ways the timing looks odd. It comes just after the placing of $10 billion in aircraft orders; and after Indian Airlines went for an expensive image makeover and change of name (aping Swiss and Emirates), which has achieved little.

Previous efforts to bring the airlines closer together—including the appointment of a joint chairman in the 1990s—have been stymied by political interference and stubborn turf-conscious managers. Mr Patel presumably sees a full merger as the best way to crash through that resistance, and is being even more ambitious by proposing that there should be a stockmarket flotation, with the government selling perhaps 10% of its shares. A consultant is to be appointed soon to advise the airlines, and joint committees will look at areas of potential co-operation such as schedules and engineering.

Sceptics believe that an immediate full merger is unworkable because the airlines' combined workforce of 33,500 will continue to cling defiantly to historically different traditions, pay scales, promotion arrangements, and other benefits. “It would be extremely unwise to go for a full merger without the first stage of a holding company,” says Probir Sen, who was one of the joint-chairmen. He favours a step-by-step approach, with a full merger after perhaps seven years. The Indian government seems inclined to be bolder.

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Alternative energy

The H prize

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A helping hand from government for hydrogen power

WHETHER for God, glory, or simply the cash, big prizes often inspire tremendous feats of courage and innovation. But is there a modern-day “Lucky” Lindbergh lurking in obscurity, hoping to cash in on the promise of a $100m “H Prize”? That is the potential payout from a scheme now working its way through Congress, that its sponsors hope could help break America from its “addiction” to foreign oil.

Congressman Bob Inglis, a Republican from South Carolina and head of the House of Representatives' Hydrogen Caucus, is sponsoring the H Prize, in an effort to spur development of a hydrogen-based economy. On May 10th his bill was voted through the House by 416-6 votes, and it now awaits approval by the Senate and the president.

If the H Prize succeeds, it would not be the first time that the promise of prize money motivated an assault on a daunting technological challenge. A $25,000 prize offered in 1919 convinced a barnstormer named Charles Lindbergh to attempt a solo flight across the Atlantic in 1927. Seventy-seven years later, the $10m “X Prize” provided the impetus for Burt Rutan's *SpaceShipOne* to make a pair of manned flights into space.

The H Prize would spread its largesse out over a decade—offering a $1m payout every second year for an advance in hydrogen production, storage or distribution technology. A further $4m would be presented in alternating years for breakthroughs in hydrogen-powered vehicles. And the grand prize—$100m—would eventually be awarded for paradigm-shifting “wells-to-wheels” technology, covering everything from production to vehicle manufacturing.

Mr Inglis's bill is a sign of the growing political demand to deal with America's ever-increasing dependence on foreign oil, and more immediately, with petrol prices that have doubled in less than two years. Both Republicans and Democrats see political mileage in the idea, ahead of the mid-term elections. Mr Inglis says he is expecting support from the White House.

Hydrogen is viewed by many as the fuel of the future. Use it to power a car, for example, and water vapour is all that spills from the exhaust pipe. But even though the gas is the most abundant element in the universe, it is not found naturally in its free and usable form. Finding ways to produce hydrogen cheaply and efficiently is an enormous task, as is shipping and storing it. Most big carmakers are working on hydrogen technology, and many believe it could be commercialised within the next decade—provided there is a supporting infrastructure. The H Prize could help to spur its development.

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Mining in Zambia

The copper phoenix

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Zambia's copper industry is coming back to life

A COMBINATION of nationalisation and falling prices almost finished off the Zambian copper industry. But privatisation and rising prices have sparked a belated revival in the country's mines.

Back in the 1970s Zambia was consistently producing more than 700,000 tonnes of copper a year. By 2000 this had plunged to just 249,100 tonnes—the least since the 1950s. Years of mismanagement by the state, crumbling infrastructure and falling prices had taken their toll. But in 2000 Zambia decided to privatise its mines and in 2002 the copper price finally began to revive. From a low of $1,319 per tonne on average in 2001, copper prices have recently touched $8,800.

Selling Zambia Consolidated Copper Mines (ZCCM), the state-owned copper monopoly, was hardly a smooth affair. It took four years of negotiations and false starts before the assets were finally privatised in 2000. But in 2002, less than two years after bagging the country's main copper mines, Anglo American (in a spectacularly ill-timed move) decided to pull out, after copper prices hit rock bottom. In November 2004 Vedanta Resources, an Indian company listed in London, stepped in and purchased Konkola Copper Mines (KCM), which remains the country's largest producer.

The new owners have undertaken massive investments to upgrade and expand existing mines and processing plants and to develop new ones. Vedanta has embarked on $800m-worth of investment in projects. These are expected to take about four years to complete. The biggest chunk is for the development of the $400m Konkola Deep Project, which should more than double KCM's ore production and expand the mine's life from 2012 until 2035. A new mine is being developed by Australia's Equinox Minerals in Lumwana in the far west of the copper belt. Canada's First Quantum Minerals started production at the Kansanshi mine last year, while a Chinese state-owned company has invested in the Chambishi mine.

Zambia's production of copper recovered to about 427,000 tonnes in 2004. Fuel shortages and labour disputes hampered production last year—but it should now rebound strongly. By 2008 the country could extract over 900,000 tonnes of copper a year—if it can ensure that energy supplies and infrastructure become more reliable.

A continuing revival in the copper price would help. This week prices wobbled, along with those of other commodities. But they are still hugely up on the year and copper bulls think that prices will be supported by the booming Chinese and Indian economies, recovery in Germany and Japan and a growing appetite for commodities as a financial instrument. Impoverished Zambia—and the foreign miners who have invested there—are banking on the bulls being right.

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Consumer businesses

The disappearing mid-market

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The urge to scrimp and splurge

"MORE of the good stuff. For less." So proclaims the new advertising campaign for Whole Foods Market, a hugely successful retailer of organic produce that, until now, has shown no interest whatsoever in being seen as a value-for-money proposition. Indeed, the firm has been nicknamed "Whole Paycheck Market". But the new ads, launched in New York, carefully draw attention to a private-label range of produce with the frugal-sounding brand name "365 Everyday Value".

Last month Mars, a big food company that owns the premium Whiskas and Pedigree pet-food brands, agreed to buy Doane Pet Care Enterprises, the largest supplier of private-label pet food to giant Wal-Mart. Days earlier Martha Stewart Living Omnimedia announced a deal to sell a new "Martha Stewart Collection" of home furnishings in Macy's department stores. The firm, resurgent since its eponymous founder's release from jail last year, already sells a "Martha Stewart Everyday" range exclusively in the downmarket K-Mart retail chain.

Each of these companies is trying to profit from what are arguably now the two most noteworthy trends among the swelling ranks of middle-class consumers around the world—trends that appear to be, at first glance, at odds with each other. These are the tendencies for consumers to be more cost-conscious; but simultaneously more willing to splurge money on luxury items.

Until the 1990s, broadly speaking, shopping choices tended to reflect spending power. The rich bought expensive things, and accounted for most luxury-goods sales. The poor tended to buy cheap, low-quality stuff. And the middle classes stuck to the mid-market.

Today, however, middle-class shoppers around the world are not content to be marooned in mediocrity. Instead, these consumers, who earn between $50,000-150,000, are "trading up and trading down" both at the same time. This change is described in great detail in "Treasure Hunt: Inside the Mind of the New Consumer", a new book by Michael Silverstein and John Butman. In an earlier book, "Trading Up", Mr Silverstein had explored one half of the change, the phenomenon of the middle-class occasionally treating themselves to luxuries that they would once have regarded as unaffordable. "Treasure Hunt" reports on the other side of that coin, the popularity of trading down—hunting for basic goods at bargain prices, not least to generate the savings that can be lavished on the occasional luxury.

Sales both at the top and bottom of the consumer market are rapidly growing while sales are being squeezed hard in the middle, though it is still the largest market segment in rich countries. Trading-up sales—those in which a middle-class consumer pays a premium of 50-200% over mid-priced alternatives—were around $300 billion in America in 2002, and are now around $500 billion (out of total consumer spending of $3.7 trillion). This is similar to Europe, where trading up is also in vogue. The trading-down market, in which middle-class shoppers pay less than the mid-market price, is far bigger, at around $1 trillion in America, Mr Silverstein calculates, up from $700 billion three years ago. This trend is also strong in Japan and Europe, especially in Germany.

But trading down is, in fact, a misleading term. One reason why this change has taken place is that the discount retailers have raised the quality of their products. A second development is the rapid increase in transparency in consumer markets, thanks not least to the internet, points out Don Tapscott, author of "The Naked Corporation". When price comparisons on Froogle are only a click away, it has become a sign of sophistication to get the best price. There is status in getting a deal.

Not everyone thinks this is a good thing, however. Americans, in particular, "have become addicted to the deal, which is leading them to do irrational things", argues Kate Newlin, author of another new book, "Shopportunity! How to be a Retail Revolutionary". One consequence is that people buy lots of stuff they do not need—a pack of 600 cookies, a gallon of pickles—chiefly because it seems to be a bargain. With so much unwanted stuff, often bought on credit, it is hardly surprising that storage is one of today's fastest-growing industries, says Ms Newlin.

Death in the middle

For companies that have made their money supplying mid-market products, times are getting harsher. At least some of the woes of General Motors, an archetypal mid-market firm, stem from the fact that in 1994-2004 the trading-up segment of the car market grew by eight percentage points, the trading-down segment grew by four, and the middle shrunk by 12.

In this bifurcated market, firms in the middle need to move either up- or downmarket, argues Mr Silverstein. He laments that such firms instead typically opt for cost-cutting, rather than taking the risk of developing new products for the consumer trading up. Often the cost-cutting is ineffective, as it reduces quality, too, whereas trading up may create opportunities. Kraft, owner of various cheese brands and other mid-market brands such as Maxwell House coffee, is a good example of a firm stuck in the middle. A few years ago, believing that the market for coffee was in long-term decline, it missed the trading-up opportunity later taken by Starbucks—one of the outstanding practitioners of the art of getting self-pampering consumers to part with their money.

Some bold firms are trying to tap both the trading-up and trading-down markets at once, which would have been unthinkable when shoppers never strayed out of their single, income-related price band. This is what lies behind Martha Stewart's move upmarket into Macy's, and Whole Foods Market's scheme to tout its cheaper range, reckons Mr Silverstein.

But neither approach is straightforward. Opinions differ over the value of creating an “affordable luxury” Martha Stewart brand in a department store. Negotiations to launch the collection at Sears, a department store that shares an owner with K-Mart, broke down in early April, apparently because Eddie Lampert, the private-equity investor who is the controlling shareholder, did not share the domestic diva's valuation of the initiative.

As for Whole Foods, its new focus on value may be a defensive response to Wal-Mart's decision to start selling organic produce at prices only 10% above its non-organic alternatives. Perhaps Whole Foods could be savaged from below, just as Tesco savaged Sainsbury—a British retailer with an eerily similar ad slogan, “Good Food Costs Less”. Companies that get stuck in the mid-market may be doomed. But as businesses trading up clash with those trading down, some of them may end up as losers, too.

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Retailing

Still on Target

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Are Target's falling margins a problem in its battle with Wal-Mart?

IT IS usually scary news for a retailer when it finds itself in Wal-Mart's sights. Before long, therefore, Target's famous bull's-eye logo could begin to look like a bad omen. Wal-Mart, after all, is now trying to make its stores more appealing to middle-class shoppers, thus taking clear aim at the “upscale discount” niche that Target, America's second-biggest retail chain, has exploited so profitably. Investors are alert for any hint that the Arkansas giant's new focus is endangering Target's earnings. So on May 15th, when the Minneapolis-based firm announced disappointing first-quarter results—including a drop in gross margins—its shares fell 8%.

Look closely, however, and Target's poor results turn out to be a mere flesh wound. Its falling margins in the first quarter largely reflect successful efforts by the company to broaden its sales beyond already strong segments such as household goods and clothing. Target is revamping its stores, to entice its customers to buy more food and other consumables, like paper goods. These have lower margins, so adding them to the product mix lowers the average margin, but revenues and operating profits—both up 12%—are growing nicely. Indeed, selling more to each customer was the main way in which Target boosted its same-store sales by 5.1% in the first quarter, thumping Wal-Mart's same-store growth of 3.8%.

Target's strategy is in many ways the mirror image of Wal-Mart's, since the two companies' product offerings are converging. Wal-Mart already lures plenty of customers to its stores through rock-bottom prices for groceries, but wants them to toss more items such as clothes and household goods into their shopping carts before heading for the till. It is also adding more expensive versions of those products to its shelves, so as to attract middle-class customers.

By contrast, Target is trying not only to sell more food, but also to appeal to the cost-conscious. The firm got caught out by stocking too many top-of-the-range household goods, and was forced to mark them down (another reason for those falling margins). But Adrianne Shapira, an analyst at Goldman Sachs, reckons that Target has learnt its lesson, and will now add some cheaper clothing to its mix.

The two chains will still keep their differences, however. Wal-Mart will remain the relentless cost-cutter; Target the trendier place to shop and save. And although both are adding stores and making money, it is still easy to tell the hunter from the hunted.

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Face value

Putting the boot in

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ROPI

Diego Della Valle has shown that there is still life in the Italian shoe industry

TO BE a real Italian tycoon you need a huge range of business and financial interests—and a football club at the apex of your empire. Silvio Berlusconi, until recently Italy's prime minister, has his media and insurance businesses—and owns AC Milan. The Agnellis are synonymous with Fiat and Juventus football club. As for Diego Della Valle—well, he is chairman of Tod's, Italy's largest high-quality shoe business, sits on the board of Ferrari and LVMH and is president of Fiorentina football club.

In normal times, football would be regarded as a harmless source of prestige and fun. But now some of Italy's biggest clubs, in particular Juventus, are enmeshed in an alleged match-fixing scandal. And even Mr Della Valle—who has often taken a rather holier-than-thou attitude in his business dealings—finds himself under investigation by magistrates over the football scandal.

Mr Della Valle insists that he will be vindicated. Indeed in an interview with this newspaper, shortly before the scandal broke, he said that he hoped to make Fiorentina an example of honesty and straight-dealing in football, adding: “But this is a very complex business. I have encountered a lot of aggression and found that the rules are set by a few.”

Fortunately, Mr Della Valle is well accustomed to controversy and rows. In the run-up to the recent Italian election, he feuded publicly with Mr Berlusconi who suggested that Mr Della Valle was a leftist who had “gone out of his mind”. A claque of Berlusconi supporters prevented Mr Della Valle speaking at a meeting of the Italian employers' association, but he was less concerned by that than the campaign that members of Mr Berlusconi's party launched to boycott shoes made by Tod's Group. “The boycott was brutal and undemocratic. It worried us and we monitored sales closely in March and April,” admits Mr Della Valle. In the event, Italian sales rose strongly in that period.

Damaging Tod's would have been a peculiarly self-defeating strategy for Italy's ruling party. For at a time when Italy's traditional industries, like clothing and footwear, are reeling in the face of global competition, Tod's is a rare example of an Italian footwear company that is going from strength to strength. Its revenues have increased to €503m ($624m) last year from €319m in 2001, and pre-tax profit improved from €60m to over €90m.

The secret of the firm's success—at a time when so many of its neighbours are going under—lies in two decisions. It has gone determinedly for the luxury end of the market, and it has invested heavily in its own brand. The average price of the roughly 2m shoes the firm produces every year is around €250 a pair.

The company, founded by Mr Della Valle's grandfather, has always made high-quality, hand-made footwear. But for many years it produced for the private-label market, making shoes that were sold in smart stores like Saks Fifth Avenue in New York and Harrods in London, under the stores' own names. The Della Valle family's crucial

decision, made a quarter of a century ago, was to launch its own brand.

“Leaving the security of those large prestigious customers for the uncertainty of building our own market was very hard,” remembers Mr Della Valle. Now 52, at that time he had been in the firm for about five years and had worked on the shopfloor, learning every job that went into the making of luxury shoes. That apprenticeship included helping to launch the brand. “We gave a lot of attention to choosing the name. It had to be easy to say, and to be spoken as read in all languages,” recalls Mr Della Valle. Now, after many years of deliberation, Tod's has launched a limited range of clothing to add to its shoes and leather goods.

A characteristic of firms in the Marches district of central Italy, where Tod's is based, is that they look outwards and explore foreign markets, says Vittorio Merloni, the chairman of Indesit, which is Europe's second largest maker of white goods and the region's biggest manufacturing firm. Exports provide just over half of Tod's revenues. The firm has 14 directly operated shops in America and the importance it attaches to that market was highlighted last autumn, when it tripled the size of its most prestigious store, on New York's Madison Avenue. It now plans to increase its presence in America—Boston, Dallas and San Francisco are candidates for stores.

China, land of opportunity

Whereas many companies in Italy's clothing and footwear industry tremble in the face of Chinese competition, Mr Della Valle sees the rise of China as an opportunity. “The boom for luxury goods is unending. There are people who never have to worry about whether they can afford something they like. In one part of the world or another there will always be someone with money to spend on luxury,” says Mr Della Valle. He sees China, where Tod's already has several outlets, as a great market. Chinese counterfeits are not a problem, nor is competition from low-cost manufacturing. “Our customers want the highest quality and that can only be found in Italy,” he asserts.

Full marks for confidence—but it is possible that Mr Della Valle is being too sanguine. Marco Boglione, a businessman in Turin whose firm owns the Kappa, Robe di Kappa and Superga footwear and clothing brands, has a different view. “China can produce better quality than we can. We only need to look and touch,” he warns. As for brands, Mr Boglione, who has recently sold the rights to the Kappa and Robe di Kappa brands in the Chinese market, believes that the Chinese will buy brands rather than build them.

So might Tod's one day come under Chinese ownership? The firm's shares were listed on the stockmarket in November 2000, and the Della Valle family still owns 65% of them—so the prospect of an eventual Chinese takeover still looks very distant. But, as the footballing adage goes, if Mr Della Valle takes his eye off the ball, he could yet run into trouble.

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Germany's export champions

The problem with solid engineering

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Germany's export machine is back in top gear, but increasingly dislocated from its home economy

vario images

ELVIS PRESLEY, Buddy Holly, Frank Sinatra, David Bowie and Celine Dion are among those who have crooned and cried into Neumann microphones, insisting that no others can so faithfully capture their voices. It is a powerful endorsement for a product that is, unsurprisingly, made in Germany. Neumann, like the companies behind many of Germany's highly regarded brands, has regained its old confidence and is expanding again. This is good news for corporate Germany, long regarded as the locomotive of the European Union. But just as these firms pull out of the station their passengers are being left behind. Unfortunately for Germany, its export champions have become uncoupled from much of the domestic economy.

Saddled with some of the highest labour and tax costs in Europe, German companies compete at the top end of the market by devising excellent technical solutions, supplying reliable goods and building long-lasting relationships with their customers. But the very qualities that enable this—over-engineering, obsession with detail and an extreme emphasis on safety and durability—come at a price: expensive products built to last. These do not bring much repeat business and tend not to spin off many new firms to create additional jobs. Fast-moving mass-consumer markets, ruled by the simplification of products, pushy marketing and dramatic innovation, are much more of an entrepreneurial free-for-all.

Germany's problem is renewal. It has few obvious successors to the industrial behemoths: carmakers DaimlerChrysler and Volkswagen, chemical giants BASF and Bayer, and Siemens, a conglomerate. These are powerful companies, but they are trapped in industries that face growing competition from younger, more vigorous firms in Asia. Smaller German companies, the famous *Mittelstand*, face difficulties of their own. Their founders are often reluctant to pass on ownership of their firms or to change direction. Most are dedicated to improving their products rather than taking risks with new ones.

Much of this risk aversion can be traced back to Germany's post-war economic miracle, the *Wirtschaftswunder*. Most *Mittelstand* companies sprang up in the absence of competition with capital provided by the Marshall Plan. Being an entrepreneur in Germany these days is not so easy. The red tape involved in starting a new company, the cost of hiring and firing in a protected labour market, and the stigma that is still attached to those who go into business and fail, complete the picture. In Germany too few companies are being born. Even the successful exporters are increasingly using imported materials or outsourcing much of their production. What is made in Germany is often the work of only a few highly skilled people engaged in an inexorable pursuit of quality and precision.

Neumann is a classic example. Inside its microphones is a capsule containing a diaphragm that vibrates near-perfectly when converting sound-waves into electric impulses. It is designed to withstand the decibels of the loudest rock band or even the noise of a Formula 1 racing car. The capsules are made in ultra-clean conditions—a speck of dust could ruin the effect. The average one will last 22 years before it needs repair, says Wolfgang Fraissinet, president of marketing and sales at Neumann's base in Berlin.

Neumann was sold by its family owners in 1991 to Sennheiser, another traditional microphone producer. Its best microphones can cost more than €5,000 ($6,450). Yet the company is not insulated from the fast-moving digital world. It is investing €1.4m to develop digital microphones. “Someone will do it, so we decided it should be us,” says Mr Fraissinet. Like its analogue predecessors, these are aimed at the top of the market and an early model was used to record the soundtrack for the film epic “The Lord of the Rings”.

Companies such as Neumann are Germany's “hidden champions”, according to Hermann Simon, a former professor at Mainz University and now a consultant. He calculates there are more than 500 of these sometimes less well-known firms doing their bit to help Germany's exports. Many are small and still family owned, but have won themselves a niche in the global marketplace and defend it by constantly reinvesting in high-end innovation and placing a supreme emphasis on quality.

Another champion is C. Bechstein, a piano-maker, which shows just how far German companies will go in order to maintain quality. “We give the instruments a soul,” says Klaus Schulze, a master piano technician and large shareholder in the company which he runs. Each Bechstein grand piano takes up to 500 man-hours to build over the course of a year. Some aficionados believe the result is a softer, more intimate sound than an American Steinway or a Japanese Yamaha.

Bechstein is broadening its product range. It bought Zimmermann, an East German producer, in 1992 and now makes a range of pianos to less demanding standards in the Czech Republic, America, Indonesia and China (in a joint venture with Samick of South Korea). But its finest instruments are made in Germany. The company insists on the absolute calm and stability of its factory in Seifhennersdorf, near the Czech Republic. “We thought of locating production in Berlin or Leipzig, but there would have been too much to distract the workers,” says Mr Schulze.

Even a company selling humble screws and hand tools goes to extraordinary lengths to keep up standards. Würth's power drills may be made in China or the Czech Republic, but they are branded with the Würth label only when they have passed the company's rigid quality controls. They can then carry its guarantee. Nine out of ten of Würth's 2.8m customers are professional craftsmen. The company also operates in the do-it-yourself end of the market, but with different brands: Meister and Connex.

Würth is a trading company that directly manufactures only 5% of what it sells. Only 60% of its goods are made by German companies, and only 25% of its profits come from Germany. It has tripled its turnover in the last ten years, to €6.9 billion. The company's strategy is to buy up firms at home and abroad and instil its own standards of quality. It now owns 355 firms in 81 countries. To improve its logistics, the company is now automating its vast warehouses at Künzelsau, which means there will be less work for unskilled people in the region.

Because of inflexibility in the labour market and high labour costs, German companies do much of their labour-intensive production abroad, keeping the capital-intensive operations at home. This has led some to argue that the increasing globalisation of German firms is costing jobs. Hans-Werner Sinn, the head of Ifo, a Munich-based research institute, has published a book called “The Bazaar Economy”, which explores the dislocation of Germany's export champions from the rest of the country. The share of imported inputs to German goods destined for export increased from 30% to 39% between 1995 and 2002.

Although German companies still pay their workers at home a good wage, that is little consolation to the unskilled who see their jobs migrating abroad. Mr Sinn recognises that companies must build factories where they are most efficient—in Slovakia, say, rather than Germany. But for the economy as a whole, he calls it a “second-best solution”. He believes a more flexible labour market, which might provide more employment at home, would be a better solution. Only then would demand in Germany begin to rise to match the booming demand for German exports (see chart), which has persisted even while the rest of the economy is in the dumps.

Other economists are less alarmed by the idea of Germany as a turntable for exporting goods. Mr Sinn is not looking at the whole cake, which is getting bigger, says Klaus Brenke of DIW, a Berlin research institute. Although the share of inputs from abroad has risen, the total volume of goods exported has risen faster, he adds.

Yet the world's biggest exporting nation is not creating jobs for the unskilled. Germany's unemployed include a high proportion of long-term job-seekers. More than 40% have been looking for jobs for a year or more, according to the latest figures published by the Federal Labour Office. Almost 27% of all unemployed people have no qualifications and around a quarter are 50 years old or more. Solutions tried so far by successive governments have not worked: they have tended to set perverse incentives, such as tempting some workers to switch to subsidised jobs and school leavers to quit the parental home for subsidised housing.

Germany's export champions rightly do not see that as their problem. Manfred Wennemer, the boss of Continental, a big tyre-maker, recently took some political flak when he decided to close a plant at Stöcken near Hanover, the company's heartland. The closure, now due at the end of 2007—a year later than was first planned—will affect 320 workers. “My duty is to my 80,000 workers worldwide,” says Mr Wennemer. He also believes that if wages were set by the market, Germany's unskilled labour pool would be more competitive.

That would still not prevent the migration of labour-intensive production to central Europe, China and other parts of Asia. Western Europeans are not likely to accept wages of a dollar or so an hour. Continental, for example, employs 1,000 workers at a plant making tyre sensors in China, whereas production of the same sensors in Ingolstadt in Bavaria is fully automated. The only difference is a slightly higher failure rate of two parts-per-million in China, compared with 0.8 in Germany. The pursuit of perfectionism is costly, but not always necessary. But if you are making machine tools and other devices which will be used by companies wanting a near-zero tolerance of failure, then dedicated precision is required and that reinforces the legend of made in Germany.

Risk aversion

Whether hidden or not, Germany's export champions have their limitations. They solve problems brilliantly. German inventors also register plenty of patents, but usually this is within parameters set by others. An historical problem is the German public's aversion to risk in scientific experiments, such as testing genetic or biological products, or extending nuclear technology. “That kind of research would really have suited us,” says Mr Wennemer of Continental.

In the 19th and early 20th centuries Germany was the pharmacy for the world. Now there is only a handful of small pharmaceutical firms left. In March, however, Bayer and Schering agreed on a merger that might provide a German contender able to compete with the world leaders. The anti-capitalist movement has a lot to answer for, says Peter May, a professor at INTES, an academy for family-owned firms in Bad Godesberg. He blames it for engendering a “fear of the future and resistance to new branches of research”. While the Anglo-Saxons developed a dynamic version of capitalism, “We had Karl Marx,” he says.

Although technical education at many German universities is excellent, and local companies make good use of it, there is a need to spend more to extend the scope of research and development, say economists and businessmen. There is also a need to improve education on a more basic level to reduce the number of unskilled school leavers who do nothing more than join the ranks of the unemployed.

The companies under most pressure in Germany are the automotive suppliers. Ever since Ignazio Lopez, a General Motors purchasing manager, made a name for himself squeezing suppliers at Opel in the early 1990s before moving on to Volkswagen to do the same thing, the parts suppliers have been caught in a constant battle of cost against quality. Continental was quicker than most to see the need to cut costs. It has also been clever at forming partnerships with diverse manufacturers, tailoring components for vehicle “platforms” (a shared chassis) and developing new technologies. Continental recently joined Volkswagen, Porsche and ZF Friedrichshafen, a chassis specialist, to help develop hybrid diesel/electric vehicles. Such close relationships with business customers suit the company well.

The exception

The same sort of relationships also suit SAP, which is based in Walldorf, Baden-Württemberg, and is arguably one of the German firms with the strongest position to compete in growing world markets. But SAP is something of an exception because it was started in 1972 by a group of rebels from IBM. It is now the world's biggest supplier of business software, although Oracle and Microsoft are snapping at its heels.

SAP is firmly rooted in Walldorf, where some 90% of its staff are German, but the company is thoroughly international. It has operations in America, Japan and the rest of Europe. Its German aptitude for problem-solving, complex engineering and precision shines through. “We don't oversell, we deliver, we thrive on peer relationships,” says Henning Kagermann, SAP's chief executive.

Can Germany's big companies and its ranks of champions drive the economy through to the next century? The industrial sector relies heavily on the automotive industry (3.7% of GDP), chemicals (2.2%), mechanical engineering (3.3%) and electrical engineering (3.2%). Even if you argue, as does a recent study by the Boston

Consulting Group together with Siemens and Deutsche Telekom, that information and communications technology make up a bigger proportion of German industrial output (6%) than do the traditional industries, that is a bit misleading. The calculation includes fixed-line telephony and the IT components of traditional industries.

Germany's economic future is still heavily dependent on the health of the auto industry, although that industry is becoming increasingly wedded to electronics and computer science. But there is no guarantee that car firms, however smart they have become at cost-cutting, outsourcing and upgrading their technology, can survive as engines of German economic growth.

SAP alone could not replace them. Nor, probably, could the production of more sophisticated chemicals. What is lacking are links between the research done in universities and the small entrepreneurial start-ups that have been the secret of so much development in Britain, America and elsewhere. The big companies work well with the universities. SAP draws liberally on expertise from the local citadels of learning: Mannheim, Karlsruhe and Saarbrücken. Last November Continental launched a research consortium led by the university of Darmstadt to promote “global engineering excellence”.

Certain industry “clusters” have developed in the state of Baden-Württemberg, which may one day replace the automotive clusters around Stuttgart, Munich and Leipzig, and the old smokestack cauldron of the Ruhr. Germany is also home to two leading international logistics companies: Deutsche Post (which owns DHL and now Exel) and Deutsche Bahn. German firms are among the best in wind-farm technology and solar panels. But that may not be enough when almost 5m people are unemployed and the service sector is developing slowly.

In Britain in the mid-1980s unemployment was equally high. The slow remedy over a decade was the creation of many service industries. But Germany is still struggling to find a policy mix that might inspire the same level of enterprise. Germany's regional and federal politicians rightly see education and integration of the non-German population as a priority. Without that, the numbers of unemployed will only grow.

That calls for greater entrepreneurial spirit and a willingness to acknowledge that business failure is as much part of a thriving entrepreneurial culture as is business success. At a conference on entrepreneurship in Bavaria earlier this month, the notion of a prize for entrepreneurs who have failed in business and have bounced back—a sort of “phoenix” prize—was discussed only half in jest.

Even the most outward-looking of Germany's export champions would get a boost if the country's economy grew faster. Professor Sinn believes Germany needs to change course if it is to avoid a total annihilation of labour-intensive industries. The enormous export surplus is damaging, he argues, and to some extent self-defeating. Companies that ignore the home market and concentrate on intermediate goods rather than consumer ones are also missing opportunities.

Puma and Adidas, two rival sportswear manufacturers from the same Bavarian village of Herzogenaurach, show that some German firms can compete in big consumer markets. Puma shifted its production abroad more than a decade ago, retaining design and marketing at home. Adidas recently bought America's Reebok in a bid to rival Nike, the world's leading sports brand. Hugo Boss, a fashion house based in Baden-Württemberg, has also built a global consumer brand.

But these are exceptions to the German stereotype. An optimist might advise more patience as companies in Germany's traditional industries will run their course and spin-offs and start-ups will eventually take their place—with or without a change in public policy. But Germany's policymakers could make a difference sooner if they dared to be inventive.

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Financial markets

Playing with fire

May 18th 2006
From The Economist print edition

Macroeconomic fears have afflicted the world's financial markets

PRUDENTBEAR.COM, a website that attracts the Jeremiahs of financial markets, carried a bleak commentary on the dollar on May 11th, laced with foreboding about American trade data, due the next day. “Can there be any doubt that the nation's record current-account and trade deficits have begun to take a serious and growing toll on the dollar? I think not.”

The writer, an American financial consultant named Douglas Gillespie, went on: “I remind readers that the stockmarket crash in October 1987 began months earlier as a dollar problem, that then became an interest-rate problem, that then became a stockmarket problem—a very, very big stockmarket problem!”

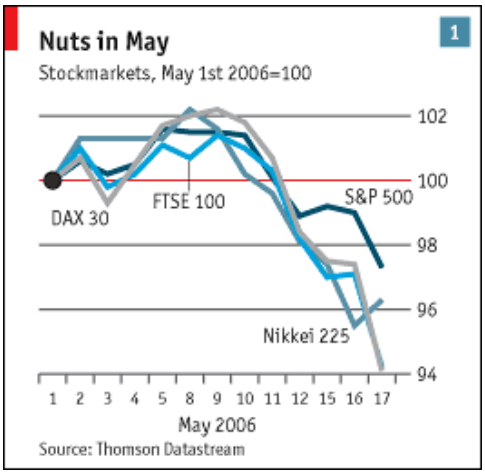
As it happened, the next day, May 12th, the dollar's broad trade-weighted index plunged to its lowest level since 1997. In the next few days, the dollar was followed downwards by the prices of all sorts of assets, including shares, bonds, gold, industrial metals and oil.

After a steadier couple of days, more trouble landed on May 17th in the shape of poor inflation data. America's “core” consumer-price index, which excludes food and energy prices, rose by 0.3% in April. Bond yields rose a bit, as you might expect, but the stockmarket took a pasting: down went the S&P 500, by 1.7% (see chart 1). In Europe, where the euro area's core inflation rate (defined slightly differently) also rose, share prices tumbled too. All this has left investors questioning whether the combination of rising inflation and inflationary expectations with worries about a weakening dollar and uncertainty over the global economic outlook is spelling the end of a bull run that has driven many asset prices to, or close to, records.

Worse still, some (and not just bears such as Mr Gillespie) saw what Richard Cookson, of HSBC, a big bank, who is a former *Economist* journalist, called “echoes of 1987”. So far, as Mr Cookson pointed out, it is hard to argue that financial conditions are anything like as severe as those leading up to that year's stockmarket crash. But just as it did then, much depends on how policymakers handle the slippery dollar and jumpy inflation. Leading that effort is Ben Bernanke, chairman of America's Federal Reserve, who is as untested in coping with macroeconomic disturbances as Alan Greenspan was when he took over the central bank two months before the stockmarket crash in October 1987.

It is on Mr Bernanke's shoulders that investors believe some of the responsibility for the recent bout of market instability lies—though not all of it, by any means. He has yet to establish his credibility with Wall

Street: since he took office in February, yields on ten-year bonds, which had been remarkably stable, have climbed by more than half a percentage point. Partly, this has reflected a pick-up in global growth, which tends to push yields up. But recently, it is the component of bond yields that measures inflationary expectations that has increased most sharply. According to Francesco Garzarelli, chief interest-rate strategist at Goldman Sachs, the expected inflation rate implied by the prices of indexed Treasury bonds has risen almost to the same level, around 2.75%, as it was before the Fed began tightening monetary policy in mid-2004.



It has risen particularly steeply since Mr Bernanke's congressional testimony last month hinted that the Fed might pause after raising rates to 5% (a level they reached, as expected, on May 10th). Since that speech, the decline in the dollar has accelerated. And now Wall Street has this week's inflation data to worry about. “The markets are unambiguously signalling unease about the inflation-fighting credentials of the Federal Reserve,” wrote Tim Bond, of Barclays Capital, even before the latest turbulence.

A survey of fund managers by Merrill Lynch, published on May 16th but conducted a few days before the markets screeched into reverse, bore out the impression of an inflation scare. The balance of those believing the global economy was operating above a sustainable long-term trend, which would be inflationary, turned positive during the past quarter. Meanwhile, almost two-thirds of fund managers expected core inflation to be higher in a year's time, compared with less than half in February.

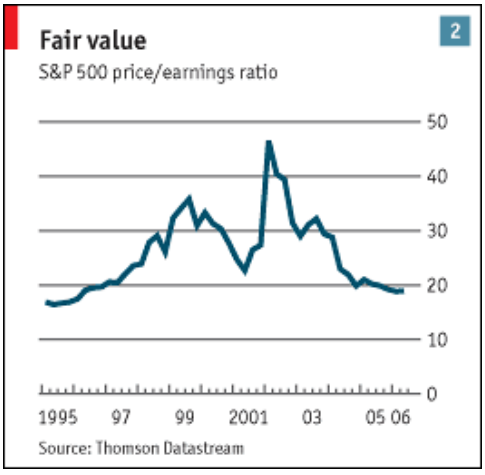
How much higher inflationary expectations—and to quell them, interest rates—will go is the question. In the months ahead, any hint of a surge will be likely to send markets into spasms, bringing to an end an unusually long placid period that had encouraged investors to embrace the riskiest of asset classes.

Such unsteadiness, like the swaying of an overcrowded train, caused a minor crush in commodities and emerging markets, two of the most overheated asset classes, early this week. The price of gold, which had risen by almost 70% in a year to $720 an ounce, its highest for many years, fell to $689. On May 15th the price of copper dropped from a record near $8,800 a tonne to $8,400. Emerging markets, especially hotspots such as Turkey and India, also tumbled.

All these markets still look unsettled, even though gold recovered as the dollar weakened and the steep falls in other commodity prices have not continued. The price of copper, for instance, has jumped around at levels a few hundred dollars below its peak.

Meanwhile, believers in the bull market in global equities have suffered a nasty graze, though not yet a full goring, from the past week's activity. HSBC notes that company profits are showing no signs of weakening, despite higher raw-material prices: those of firms in the S&P 500 index were up by 14% in the first quarter. Strong earnings mean that shares do not look overvalued. Despite the S&P 500's strength since the start of the year, the price/earnings ratio is barely higher than it was in 1995 (see chart 2). Optimists would say that shares now look even better value. Although the stockmarkets' cheerleaders expect American growth to ebb in the second half of the year, they hope that Japan and Europe will take up the slack. There has also been a resurgence of mergers and acquisitions for which companies are raising debt and equity. Unless the merger activity becomes manic, it may also help stockmarkets along.

But even those who have profited from the long bull market acknowledge that there are risks. The research director of one of the world's largest hedge funds talks of a “happy-chappy” environment in which mainstream investment funds and hedge funds have pursued the same strategies recently, jumping from bonds to equities and then to currencies and on to emerging markets. For too long, they have ignored inflation despite high commodity prices, he says.



There are other risks beyond the immediate concern with inflation. If policymakers do respond to rising inflationary expectations by raising interest rates further than they would otherwise have done, the deeply indebted consumers of many English-speaking economies will be hurt. So will the still-giddy housing markets of several countries.

The skill with which policymakers handle a declining dollar is another cause for concern. The currency has fallen sharply since April 21st, when the G7's finance ministers appeared to endorse a weakening of the dollar by calling on China to let its currency rise. The sense that there may be a concerted effort to weaken the American currency has been nicknamed “Plaza-lite”, after the “Plaza Accord” in

1985 which did just that—with disastrous consequences for stockmarket investors two years later.

Mr Bernanke told Congress last month that because of the size of America's current-account deficit, there was “a small risk of a sudden shift in sentiment that could lead to disruptive changes in the value of the dollar and other asset prices.” He knows that markets are now playing with fire. More bad news on inflation, or any false moves on his part, will heat up inflationary expectations and cause more trouble for the prices of shares, bonds and other assets. What the markets do not yet know—partly because he has not had time to prove himself—is how good Mr Bernanke is with a fire extinguisher.

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Gulf stockmarkets

Ups and downs

May 18th 2006 | DUBAI
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Arab investors' roller-coaster ride

THE shakiness of Western stockmarkets in recent days is nothing compared with what has been going on in the Gulf. Markets there have plunged in the past few months after four years' rocketing growth. In the trading week that ended on May 11th, the Saudi Arabian market shed a fifth of its value. Its total value dropped below $400 billion, less than half the February peak. Then the index leapt by 20% in two days, before losing half the recovered ground on May 16th.

AFP

Sit down and take a deep breath

The oil boom and the liquidity that washes in its wake explain much of the turbulence in the region's markets. With fuel fetching twice what it did just three years ago, Gulf economies are chalking up record growth. Corporate profits are surging as well as trade surpluses and government budgets. Profits in the six monarchies of the Gulf Co-operation Council rose by 31% in the year to the first quarter of 2006, reports SICO, a Bahraini investment bank. This was slower than the 63% of the preceding year, but impressive nonetheless.

Yet it is simple immaturity, rather than too much cash, that explains the roller coaster. Even more than in previous stockmarket bubbles elsewhere, weak regulation, a lack of large marketmakers and a proliferation of small traders have combined to turn over-exuberance into overkill.

For months, brokers and even central banks had given warning of an impending crash in the region's stockmarkets. Most institutional investors did get out. But millions of retail investors, by some estimates representing three-quarters of the region's households, are believed to hold some 60% of freely floating shares. (By contrast, barely half of American households own equities—and then mostly through mutual funds.) Their enthusiasm was encouraged by banks, which eagerly lent them money to buy shares. And some well-meaning governments fed expectations by deliberately underpricing privatisation issues as a way of redistributing the oil windfall.

With regulators failing to enforce disclosure rules, and with cautious big investors overtaken by the herd of small punters, volatility was to be expected. An example is that of Emaar, a property developer based in Dubai: although few of Emaar's huge projects have yet been built, its market value soared to $45 billion before slumping lately to $18 billion.

Like others in the region, the Saudi index is now quivering on low volumes. Some analysts predict a further dip, citing price/earnings ratios that are still well above the average for emerging markets. Others argue that even if values look high compared with elsewhere, this only reflects the strength of a well-oiled economy running at full throttle.

Barring *force majeure*, the bulls have the better argument for the longer term. Most experts expect the price of oil

to remain high, and Gulf governments have grown far wiser in managing their wealth. It is only a matter of time before the region's markets and regulatory standards mature, and its economies look set for sustained growth. One seasoned local economist predicts that by 2030 the Gulf monarchies will make up the world's sixth-largest economy, after China, India, America, the European Union and Japan.

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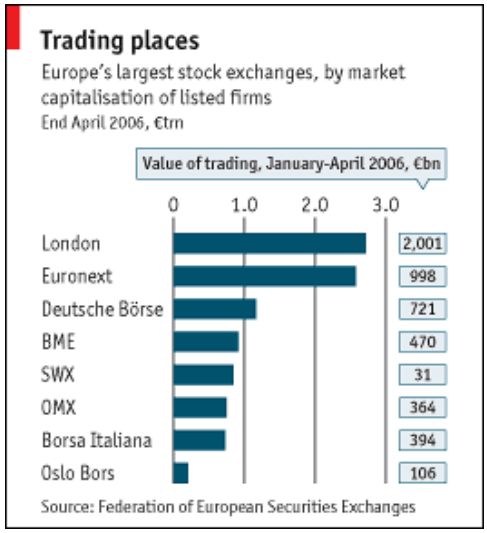
European exchanges

Crowding the dance floor

May 18th 2006 | LONDON, MADRID AND MILAN
From The Economist print edition

As merger talk heats up, two more bourses consider going public



THE drama playing out between Europe's top financial exchanges is becoming even more gripping, thanks in part to restless shareholders. With the three biggest listed exchanges—the London Stock Exchange (LSE), Euronext and Deutsche Börse—facing ever more speculation about cross-border alliances, two smaller bourses in Europe are preparing to go public and possibly join the throng.

On May 23rd Euronext's shareholders will vote on a resolution proposing that management pursue a merger with Deutsche Börse. The move is backed by groups of investors, notably hedge funds, controlling at least a third of Euronext's shares.

Yet Euronext's board and its chief executive, Jean-François Théodore, oppose the resolution, fearing its passage will tie their hands in negotiations. With only a few days left before they face impatient shareholders, Euronext's executives must show that they have an alternative.

Hence the flurry of activity. Mr Théodore, who is based in Paris, has long favoured an alliance with the London exchange, but its share price has doubled in the past six months. In addition, any deal has been complicated by NASDAQ's recent grab of about 24% of the LSE's shares. This puts the American exchange in a strong position to ward off another potential bidder for the LSE, although a downgrade of NASDAQ's credit rating to junk status this week by Standard & Poor's may limit its options.

With London out of reach, Euronext has turned to other potential partners. The New York Stock Exchange (NYSE), NASDAQ's big American rival, and Borsa Italiana, based in Milan, are seen as possibilities. Executives of the Chicago Mercantile Exchange, a derivatives giant with global ambitions, were also in Paris this week—to watch football, they insisted.

As *The Economist* went to press on May 18th, Borsa Italiana's shareholders met in Milan to consider plans for an initial public offering, which is favoured by Massimo Capuano, the chief executive. But at least two big banks among the bourse's largest shareholders were reported this week to harbour reservations. As exchange users, they fear that if it goes public, it may face the sort of shareholder activism exerted on Euronext by London hedge funds.

If the exchange's owners balk at a listing, Mr Capuano will be forced to consider alternatives. A source close to the exchange says a share swap with Euronext, which already runs several exchanges in Europe, could be possible. Sitting last week in his spacious office, which is filled with souvenirs from companies that have listed on his exchange, Mr Capuano said that he was cooler about the idea of an alliance with the LSE than he had been in the past.

Meanwhile, shareholders in Bolsas y Mercados Españoles (BME), a holding company for Spain's four regional exchanges, will vote on June 5th on whether to go public. “Every exchange with a minimum volume and size is asking ‘Why not me?',” says Javier Hernani, its chief financial officer.

The task for the mid-tier exchanges in Europe is to keep pace with their bigger rivals as trading becomes more global. Benn Steil, an expert on exchanges at the Council on Foreign Relations in New York, says that BME, Borsa Italiana, Switzerland's SWX and OMX, a Nordic exchange operator, all have lower operating margins than the big three. Technological demands, driven by hedge funds and algorithmic trading, mean that exchanges have high fixed costs. Yet with few blue-chip stocks on their books, the middle-sized exchanges have less revenue from trading and listing to offset those costs.

The reliance on only a handful of large issuers at the mid-tier exchanges “is a very serious position to be in,” says Mr Steil. “They either need to do a technology deal or be consolidated.” Officials at both the Italian and Spanish

exchanges lament the relatively small number of issuers. In Italy, for instance, companies with well known international names, such as Armani and Illy, remain family-owned.

As for the other mid-tier exchanges, SWX is mutually owned by 51 mostly Swiss banks. Although it has announced no plans to go public, its new chairman is studying what he might do. OMX, meanwhile, is public and has a healthy trading business in several countries, as well as a strong technology unit. Its chief executive, Magnus Bocker, says that consolidation should chiefly benefit exchange users. “A merger built solely on shareholder value and cost issues will fail,” he says.

Another factor for all Europe's exchanges to consider is a far-reaching regulation known as MiFID, due to take effect in November 2007. Analysts say Euronext, BME and Borsa Italiana are especially vulnerable, because it would remove rules that in effect eliminate competition in their home markets. A public listing or, better, an alliance before that change comes into force is therefore all the more attractive.

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Chinese banks

A muffled report

May 18th 2006 | HONG KONG
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An attempt to estimate China's bad loans backfires

ALTHOUGH China likes most of its numbers to be big, it has been trying to reduce one of them: the size of the bad loans burdening its banks. A report this month by Ernst & Young, a big auditing and consulting firm, therefore came as quite a shock. Ernst & Young, which does plenty of work on the mainland, claimed that China's stock of non-performing loans (NPLs) added up to $911 billion. This is more than five-and-a-half times the latest government estimate of $164 billion, published in March. The report deemed the country's big four state-owned banks, which are trying to attract international investors, to be carrying $358 billion of bad loans, almost three times the official tally.

The People's Bank of China, the country's central bank, quickly attacked the research as “ridiculous and barely understandable”. This week an embarrassed Ernst & Young withdrew it, admitting that it was “factually erroneous” and that it had somehow slipped through the firm's normal checks. Ernst & Young says it plans to publish a revised version in due course.

The authorities' savage reaction is easy to understand. Other commentators and consultants have published estimates of China's NPLs ranging from $300 billion to $500 billion without attracting similar condemnation. Ernst & Young's estimate stood out not only for its size but also for its timing. The central bank's rebuttal came on the very day that Bank of China, the second of the big four to attempt a stockmarket listing in Hong Kong, began its investor roadshow. Bank of China plans to raise $9.9 billion, even more than the $9.2 billion pulled in by China Construction Bank, which was floated last October. A third big bank, Industrial and Commercial Bank of China, hopes for $10 billion in September. Awkwardly, Ernst & Young is this institution's auditor—and as such had subscribed to the official, much lower estimate of bad loans.

Even so, the firm's categorical withdrawal of its research looks like an overreaction. The report was more than a compilation of historic bad debts; drawing on work by other organisations, it also made a stab at estimating the new NPLs that will result from a lending spree between 2002 and 2004. These account for most of the difference between Ernst & Young's figures and the official ones. And they are particularly relevant now that the mainland is in the midst of another credit surge: new loans in April amounted to 317 billion yuan ($40 billion), more than twice as much as in the same month last year. Although China has made progress in shifting bad loans off the banks' balance sheets, there is little sign that the banks themselves have fundamentally changed their behaviour and become rational lenders.

Neither side emerges with much credit from this episode. Ernst & Young seems to have caved in too quickly to Chinese demands, at a cost to the perceived independence that it needs to win respect and clients. The Chinese authorities, meanwhile, look like bullies. Bad loans are almost certainly greater than the official numbers say, even if they are less than Ernst & Young's estimate. To deny this is naive and damages the credibility needed to sell NPLs and shares in its banks to foreign investors. These, indeed, may turn out to be the only winners, if the tale reminds them of the real state of Chinese banks as another one passes round the hat.

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Payments in the European Union

Cashless Wanderlust

May 18th 2006 | FRANKFURT
From The Economist print edition

A small step towards seamless cross-border banking

GERMAN tourists in South Tyrol or on the Costa Azul will soon be carrying less cash in their *porte-monnaies*. Under an agreement this week with Germany's main banking associations, Italian and Portuguese banks will accept German debit cards at cash machines and points of sale, starting next year.

This is a small but significant step towards the European Commission's goal of making payments between European Union countries as easy as they are within them—an idea known as the single European payments area, or SEPA. It will help not only tourists but also shopkeepers, who will have to pay intermediary banks as little as one-tenth of what they now do for credit-card transactions and half of today's fees for Mastercard's pan-European Maestro debit card.

The banks' decision will thus cost them revenue, at least in the short run. They are also taking a step away not only from Maestro but also from a pan-European payment method being touted by Visa, Mastercard's rival credit-card association.

The commission wants cross-border payments to be seamless by January 2008. That can be done reasonably cheaply by making national systems interoperable: in a study published this week, Boston Consulting Group (BCG) puts the likely cost to banks at €500m ($640m). Three years after that, however, is the deadline for a single European payments mechanism. Everyone agrees that this will be far harder and cost much more: €5 billion, reckons BCG. The commission used to insist that a pan-European scheme must replace national systems by the end of 2010. Now it speaks of a gradual “market-driven migration”.

BCG's study says that the banks' best tactic would be to lobby for a delay to SEPA's 2010 deadline. This is because it makes sense to fit the replacement of cards, payment infrastructure and related elements in with the banks' own investment cycles. These do not necessarily match the commission's timetable.

Even the commission admits that individual banks have a case when they argue against investing so much money for the small proportion of their customers who make cross-border payments. Nevertheless, it is convinced that the spending makes sense for the EU as a whole; and its direction is set. Earlier this month the commission and the European Central Bank (ECB) gave warning, in a joint statement, that the level of service by the end of 2010 would have to be “at least as good as existing national instruments, but preferably better.”

The German/Italian/Portuguese project is supported by the ECB, which has tended to favour a market-driven approach rather than one governed by decree from Brussels. Other countries are expected to join, although the French banks may go their own way. It is no big surprise that the Germans, Europe's most eager tourist nation, were first to sling their towels over the sunbeds.

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University bonds

An education in finance

May 18th 2006 | NEW YORK
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America's colleges embrace the capital markets

IN THE lecture halls of America's universities, capitalism is far more likely to be damned than praised. Those who run the universities, however, have a keen appreciation of the capital markets. It is well known that some institutions, notably Harvard, have benefited greatly from putting top-notch managers in charge of their endowment funds. Less well known is the increasing willingness of colleges to borrow in the markets, too. On May 15th, for example, Cornell University sold $250m-worth of bonds. In recent weeks both Harvard and the University of Texas have also raised hundreds of millions of dollars in this way.

Such debt-raising is becoming more common, although the average bond issue is smaller than these. Lehman Brothers reckons that the overall market for higher-education debt has tripled since 2000, to $33 billion, and there are abundant reasons besides the recent trend to believe that the market will grow much bigger yet.

Lovely, leafy assets

Largely this is because colleges are only belatedly becoming aware of how useful the financial markets can be. No doubt some of their hesitation has been cultural: academics may have been reluctant to look at their universities as businesses; or they may have misunderstood what was needed to help those businesses grow.

If they did look at their institutions in economic terms, people in education tended not to think that universities lacked capital. Rather, they thought that they had a structural inability to use capital and labour more efficiently. Unlike the car industry, say, which is continually cutting the number of worker-hours needed to assemble a vehicle, many schools felt that they must maintain, or even increase, the ratio of employees (teachers) to customers (students). Small class sizes are taken as a signal of high quality, so investing money to save on teachers' salaries is not an attractive strategy.

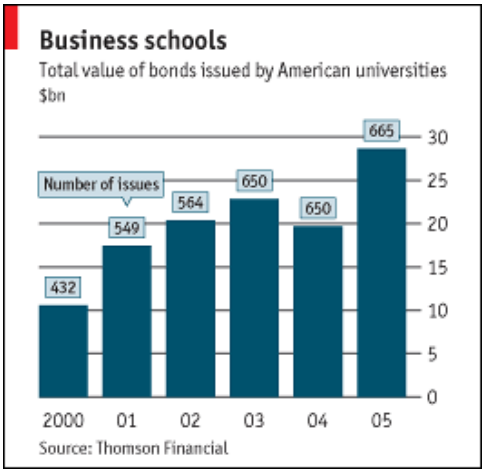
Schools had other reservations as well. Poor schools were worried about being unable to service debt. Rich schools with huge endowments ($25 billion at Harvard, $12 billion at the University of Texas, $4 billion at Cornell) may have seen no need. And college administrators may not have considered that their institutions' primary assets—reputation, inspiration and insights—were suitable as collateral.

So much for an academic perspective. A growing number of investors saw things differently. Those lovely buildings on rolling campuses, the better universities' reputations, taxpayers' backing of state-owned institutions: all this looked to them like a deep pool of assets against which lots of money could be borrowed. The money raised could be used to attract more customers, who are choosy about the product and whose demand varies little with the price (loudly though they may complain).

The idea has flourished. Colleges throughout America are building classrooms, stadiums, theatres, climbing walls and whatever else it takes to hold teenagers' imaginations. This costs a lot and much of it is financed by debt. So far, credit quality has been excellent. The last default was back in 2000, when Bradford College, an old Massachusetts institution, closed its doors leaving debts of almost $20m.

Some of the richest universities may be using another tactic too, although they would be loth to admit it. To understand this, it helps to know that America has three types of university—public ones; private, not-for-profit institutions; and private schools run for profit. Both public and not-for-profit universities often issue tax-exempt debt. This tends to be cheap. They can then invest the money they raise in the higher-yielding taxable market but, because of their non-profit status, avoid taxes. In this strategy, endowments must be the envy of hedge funds.

This is not quite a licence to print money, but it is not far off. Under a 1986 law, money has to be raised for a purpose, such as a building. However, this is a matter of substance rather than form. Money is fungible. As long as the tax authorities are happy that the promised sum is being spent on the stated projects, a university can borrow cheaply and, in effect, earn a spread. Reflecting just how complex this market has become, most universities borrow at variable rates (because investors for some odd reason seem to prefer tax-exempt paper with short maturities) and then hedge their interest-rate risk through swaps. It is all pretty clever.



There are, however, limits. Standard & Poor's, a rating agency, says that three recent downgrades show the difficulties that some universities face. The University of Medicine and Dentistry of New Jersey became embroiled in a billing scandal connected to government health insurance. Rensselaer Polytechnic Institute, a north-eastern engineering school founded in 1824, and the University of Cincinnati have both borrowed plenty in order to improve their facilities. Both no doubt judged that the return on investment, in terms of increased fees, outweighed the extra borrowing costs. Schools are acting like businesses, with all the attendant risks.

Outside America, schools have been hesitant to take this approach largely because their operations and spending are more closely tied to the state, but they too are changing, if slowly. Students everywhere are demanding better facilities and, as the state funding of higher education frays, there may be opportunities for institutions that spot them. In the past five years universities in Britain, Japan, Spain and Canada have also asked for credit ratings. Some small deals have emerged, but bigger ones are expected.

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Economics focus

The growth of growth theory

May 18th 2006
From The Economist print edition

The riddle of technology and prosperity is explored in a fine new book

FIFTY years ago, Robert Solow published the first of two papers on economic growth that eventually won him a Nobel prize. Celebrated and seasoned, he was thus a natural choice to serve on an independent "commission on growth" announced last month by the World Bank. (The commission will weigh and sift what is known about growth, and what might be done to boost it.) Natural, that is, except for anyone who takes his 1956 contribution literally. For, according to the model he laid out in that article, the efforts of policymakers to raise the rate of growth per head are ultimately futile.

A government eager to force the pace of economic advance may be tempted by savings drives, tax cuts, investment subsidies or even population controls. As a result of these measures, each member of the labour force may enjoy more capital to work with. But this process of "capital-deepening", as economists call it, eventually runs into diminishing returns. Giving a worker a second computer does not double his output.

Accumulation alone cannot yield lasting progress, Mr Solow showed. What can? Anything that allows the economy to add to its output without necessarily adding more labour and capital. Mr Solow labelled this font of wealth "technological progress" in 1956, and measured its importance in 1957. But in neither paper did he explain where it came from or how it could be accelerated. Invention, innovation and ingenuity were all "exogenous" influences, lying outside the remit of his theory. To practical men of action, Mr Solow's model was thus an impossible tease: what it illuminated did not ultimately matter; and what really mattered, it did little to illuminate.

The law of diminishing returns holds great sway over the economic imagination. But its writ has not gone unchallenged. A fascinating new book, "Knowledge and the Wealth of Nations" by David Warsh, tells the story of the rebel economics of increasing returns. A veteran observer of dismal scientists at work, first at the *Boston Globe* and now in an online column called *Economic Principals*, Mr Warsh has written the best book of its kind since Peter Bernstein's "Capital Ideas".

Diminishing returns ensure that firms cannot grow too big, preserving competition between them. This, in turn, allows the invisible hand of the market to perform its magic. But, as Mr Warsh makes clear, the fealty economists show to this principle is as much mathematical as philosophical. The topology of diminishing returns is easy for economists to navigate: a landscape of declining gradients and single peaks, free of the treacherous craters and crevasses that might otherwise entrap them.

The hero of the second half of Mr Warsh's book is Paul Romer, of Stanford University, who took up the challenge ducked by Mr Solow. If technological progress dictates economic growth, what kind of economics governs technological advance? In a series of papers, culminating in an article in the *Journal of Political Economy* in 1990, Mr Romer tried to make technology "endogenous", to explain it within the terms of his model. In doing so, he steered growth theory out of the comfortable cul-de-sac in which Mr Solow had so neatly parked it.

The escape required a three-point turn. First, Mr Romer assumed that ideas were goods—of a particular kind. Ideas, unlike things, are "non-rival": everyone can make use of a single design, recipe or blueprint at the same time. This turn in the argument led to a second: the fabrication of ideas enjoys increasing returns to scale. Expensive to produce, they are cheap, almost costless, to reproduce. Thus the total cost of a design does not change much, whether it is used by one person or by a million.

Blessed with increasing returns, the manufacture of ideas might seem like a good business to go into. Actually, the opposite is true. If the business is free to enter, it is not worth doing so, because competition pares the price of a design down to the negligible cost of reproducing it. Unless idea factories can enjoy some measure of monopoly over their designs—by patenting them, copyrighting them, or just keeping them secret—they will not be able to cover the fixed cost of inventing them. That was the final turn in Mr Romer's new theory of growth.

As useful as poetry

How much guidance do these theories offer to policymakers, such as those sitting on the World Bank's commission? In Mr Solow's model, according to a common caricature, technology falls like “manna from heaven”, leaving the bank's commissioners with little to do but pray. Mr Romer's theory, by contrast, calls for a more worldly response: educate people, subsidise their research, import ideas from abroad, carefully gauge the protection offered to intellectual property.

But did policymakers need Mr Romer's model to reveal the importance of such things? Mr Solow has expressed doubts. Despite the caricature, he did not intend in his 1956 model to deny that innovation is often dearly bought and profit-driven. The question is whether anything useful can be said about that process at the level of the economy as a whole. That question has yet to be answered definitively. In particular, Mr Solow worries that some of the “more powerful conclusions” of the new growth theory are “unearned”, flowing as they do from powerful assumptions.

At one point in Mr Warsh's book, Mr Romer is quoted comparing the building of economic models to writing poetry. It is a triumph of form as much as content. This creative economist did not discover anything new about the world with his 1990 paper on growth. Rather, he extended the metre and rhyme-scheme of economics to capture a world —the knowledge economy—expressed until then only in the loosest kind of doggerel. That is how economics makes progress. Sadly, it does not, in and of itself, help economies make progress.

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Mass hysteria

Telling the truth to the terrified

May 18th 2006
From The Economist print edition

Knowing that anxiety causes the same symptoms as poisoning could help in a biochemical attack

AP

LAST December a mysterious illness broke out in a school in the Shelkovsk region of Chechnya. Symptoms included convulsions, nausea and breathing difficulties. The illness spread to neighbouring schools. Local doctors suspected mass poisoning, but when a delegation of medics arrived from Moscow, they attributed it to mass hysteria.

Chechnya has been the scene of Russian military operations since 1994, so understandably those affected have little faith in the official verdict. Meanwhile, without knowing the nature of the suspected toxin, local doctors are at a loss as to how to treat their patients. The only way to break the impasse, public health experts say, is to send in an investigating team from outside the former Soviet block—one that the Chechens will trust. If mass hysteria is to blame, they say, the truth is the best medicine.

Zsuzsanna Jakab is director of the European Centre for Disease Prevention and Control in Stockholm but, in 1996, she worked for the World Health Organisation and helped to investigate an outbreak of illness in Macedonia. It affected schoolchildren in the mainly Albanian district of Tetovo. Dr Jakab received reports from Albanian representatives of mass poisoning, which were denied by the Macedonian authorities. She led a team consisting of a paediatrician, an epidemiologist, a toxicologist and a clinical expert. They spent a couple of weeks in the region, taking samples that were sent to laboratories outside the country for analysis, reviewing the hospital's case reports, interviewing affected families and searching for possible environmental contaminants.

The team found no evidence of poisoning, and concluded that the illness was probably caused by stress resulting from high political tensions in Tetovo. Its report was rejected both by the Albanians, who continued to stick to the poisoning theory, and by the Macedonians, who denied that a climate of fear existed in the region. Nevertheless, after the team returned to explain its findings to the families, reports of symptoms gradually subsided. Dr Jakab says that a region where conspiracy theories and fear abound is a prime breeding ground for mass hysteria. In a war zone, allegations that a toxic agent has been deployed cannot be dismissed—indeed they need more urgent investigation, she says.

A familiar problem

Mass hysteria, or medically unexplained epidemic illness, has been documented since medieval times. Simon Wessely, a director of the King's Centre for Military Health Research at King's College London, says such outbreaks tend to reflect a society's beliefs. In the past witchcraft or demonic possession were often blamed—they still are in some societies. In today's industrialised world, environmental contamination is more likely to be invoked. In 2001, after al-Qaeda's attacks on America, Dr Wessely predicted more of these outbreaks, because of the heightened risk

of terrorism and, in particular, bioterrorism. The later anthrax attack, which killed five people, was second only to the assault on the twin towers in terms of the shock and anxiety it caused the American people.

Dr Wessely distinguishes acute episodes of mass hysteria from the chronic sort. He says that he has a huge boxful of reports of the first type, which often occur among schoolchildren and are investigated rapidly. Symptoms vanish within days, once the patients have been gently reassured that their imagined cause does not exist. When an outbreak occurs against a backdrop of social trauma, it can go on for months or longer. For an episode to become chronic, patients' beliefs that they are being poisoned must be reinforced by local physicians and media. Shelkovsk may be a case in point, he says.

Whether or not the Chechen incident turns out to be mass hysteria, the patients' symptoms are real enough. What people find hard to believe, says Dr Jakab, is that anxiety-related illness can so closely mimic illness caused by an organic cause. In 1987 thieves stole a canister containing highly radioactive caesium chloride that would have been used in radiation therapy from an abandoned hospital in Goiânia, Brazil. They sold it to a junkyard owner, exposing a number of people to high doses of radiation. Some 112,000 people were screened, and 250 of them were found to have been contaminated. Yet another 5,000 people reported vomiting, diarrhoea and rashes—all symptoms of acute radiation sickness.

Dr Jakab says medical staff need to realise that the cause of these symptoms is anxiety so that patients can be treated accordingly. The World Health Organisation now has instructions describing what to do. Being told to stop faking it is unlikely to speed patients along the road to recovery. Instead, they should be removed from the stressful environment and persuaded that nothing is poisoning them except their own worries. People also need to be educated about the real risks of bioterrorism, says Dr Wessely. Ignorance breeds fear. The danger is that medical and social services will be overwhelmed, as they were in Brazil, and so take longer to identify the real victims of the incident. That, he says, is why biochemical warfare is really psychological warfare.

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Evolution

Close cousins

May 18th 2006
From The Economist print edition

Humans could have interbred with chimpanzees

IN A short story by Ian McEwan, “Reflections of a Kept Ape”, a woman takes a pet chimpanzee as her lover. Although truth is often stranger than fiction, a study published this week by scientists in America demonstrates that both can be pretty odd. The research concludes that humans and chimpanzees interbred after the two species first separated, before eventually going their different ways some 5.4m years ago. Humans are thus much more recently related to their closest relatives than was previously thought.

The researchers, led by David Reich of the Broad Institute of Harvard and the Massachusetts Institute of Technology, examined the genetic record of humans and chimpanzees. The sequencing of the human genome was completed in 2001 whereas that of the chimpanzee genome was finished last autumn. The two genomes are alike, differing by only 1.2% over the course of some 3 billion pairs of the genetic “letters” in which the language of genes is written. In fact, almost a third of the shared genes (each of which is several thousand letters long) are identical in the two species.

Instead of looking at average genetic differences, though, Dr Reich and his colleagues used the complete sequences to reveal the evolutionary history of the genomes. Scientists have long suspected that some regions of the human (and chimpanzee) genome must be older than others—that some sections trace their origins far back to the common ancestral population that gave rise to humans and chimps.

Dr Reich and his colleagues examined these common sequences, mindful of the assumption that genes steadily collect mutations as time goes by. They aligned sections of the human and chimpanzee genomes and identified how much they diverged. At different genes, humans share a common genetic ancestor with chimpanzees at different times. By studying more than 31,000 bits of the genome and measuring how closely humans are related to chimpanzees in different places, the scientists were able to study how quickly the species became different from each other. The results were published online this week in *Nature*.

The team found that it took at least hundreds of thousands of years and, perhaps, 4m years for human and chimpanzee ancestors to stop interbreeding after they began to be differentiated. Humans and chimpanzees were interbreeding for all this time, before finally separating no more than 6.3m years ago and probably less than 5.4m years ago. This is more recent than was thought. Moreover, the argument that the two species were interbreeding over such a long time is, to say the least, controversial.

Most interesting was what the scientists discovered about the X chromosome in humans and chimpanzees. The X is one of two chromosomes that determine a person's (or a chimp's) sex. Females carry two copies of the X chromosome while males carry one X and one Y chromosome. The progeny of interbreeding start with a big evolutionary disadvantage. It is thought that if human and chimp ancestors initially became separate species and then started to interbreed, then the hybrid males produced tended to be infertile. (No one knows exactly why males are more affected than females, just that they are in groups ranging from mammals to insects.) A viable hybrid population could only be created if the fertile females mated back to one of the ancestral populations.

The scientists found that human and chimpanzee X chromosomes are relatively similar. Indeed, their differences are roughly some 1.2m years younger than the average of all the non-sex chromosomes. This lends weight to the theory that a viable hybrid population was sustained by interbreeding over a long time.

Further evidence could come from the fossil record. Fossil finds are notoriously difficult to classify—people disagree on which physiological features are important; and each new find represents a class of one. The Toumai skull, found in Chad in 2001 and thought to be the earliest hominid, is between 6m and 7.4m years old. However, Dr Reich points out, if humans and chimpanzees had undergone an initial separation at this time, it could account for why the skull has human-like features, including a relatively flat face without a protruding snout. The interbreeding came after this time.

The researchers, along with other scientists across the world, are now working to sequence the complete genome of other close relatives to humans, including gorillas and orangutans. Primate evolution could yet reveal plenty more oddities.

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Pharmaceuticals

Trials and transparency

May 19th 2006 | NEW YORK CITY
From The Economist print edition

A hope that openness will help to restore trust in clinical trials

WITHOUT clinical trials, there would be no new miracle drugs. Pharmaceutical researchers could not test the efficacy, safety or anything much else about potential new treatments. So it is a pity that drug trials are under a cloud thanks to several recent scandals.

In Britain a recent early-stage trial of TGN1412, a monoclonal antibody designed to treat leukaemia, went horribly wrong; half a dozen patients were left gravely ill with multiple organ failure. Elsewhere, critics accuse Merck of withholding data from trials of Vioxx, a painkiller, that suggest it causes a higher risk of heart problems. In New York, Eliot Spitzer, the attorney general, has accused GlaxoSmithKline of suppressing data indicating that Paxil, an anti-depressant, might increase the risk of suicide in some children. The ordinary punter can be forgiven for thinking that a process designed to get at the truth is being manipulated by drug firms.

Happily, the World Health Organisation (WHO) thinks it has a solution. In an article in this week's *Lancet*, the agency unveils the results of its two-year-long effort to forge a set of universal rules for disclosing data from clinical trials. At the moment, the industry can choose from various voluntary initiatives encouraging disclosure and dozens of registries, but it is governed by few hard-and-fast rules.

With its new manifesto, the WHO hopes to change all that. It outlines 20 data requirements that must be disclosed for all trials. Provocatively, it insists that all such information must be disclosed before the first patient is registered for a trial—even for early-stage trials.

This is unlikely to sit well with the pharmaceutical industry. Caroline Loew of PhRMA, the American drug industry's lobbying arm, argues that disclosing details such as an experimental compound's proper scientific name could tip-off rival researchers that a firm has found a novel dosing regimen or a new use for an old compound. That, argues Dr Loew, would deter innovation and lead to drug companies looking for new treatments using rivals' data rather than their own research. If so, the lobbyists mutter, it would be the death of the industry.

The fears are overblown. Full disclosure early in trials might indeed make it harder for firms to protect clever new ideas. But pharmaceutical companies should still enjoy patent protection. In any case, they already routinely look for clues as to what their rivals are doing. The WHO argues that transparency could even improve the efficiency of the drug discovery process. The same firm that loses its lead on one drug might catch up or beat rivals on three others using information gained from a newly transparent process.

Sidney Wolfe of Public Citizen, an American watchdog group, even argues that these new recommendations do not go far enough. Voluntary measures will always fail, he says, because “the ones that have the most to hide will be the ones that disclose the least.” This bias toward publishing only positive research, he argues, has led to the suppression of valuable data on drug failures and thus tainted decades of clinical trials. He thinks that only full disclosure required by law will be sufficient to restore public trust in the industry.

He may be right, but even Dr Wolfe concedes that such legislation is highly unlikely to pass through Congress. Given that, the WHO's new plan for standardising and strengthening the disclosure of clinical trial data seems a good start to restoring the public's faith in clinical trials. As Ida Sim, project co-ordinator for the WHO's International Clinical Trials Registry Platform, and her colleagues argue in the *Lancet*, “sunlight is the best antidote to such free-floating distrust.”

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About sponsorship

Chinese science

Faking it

May 18th 2006
From The Economist print edition

China is developing new rules to prevent scientific fraud

WHEN taking the fast train to technical prowess, it pays to check that the drivers are competent, the engine is running smoothly and the tracks are clear. Unfortunately, China's hunger for success in the sciences is such that some have been tempted to cut corners. Some independent researchers are sufficiently alarmed to have started the unofficial monitoring of possible frauds. The need for official reform is pressing.

AP

The chips are down

Science is important to China. The country recently unveiled plans to increase its spending on research and development to 900 billion yuan ($112 billion) by 2020. By that time, it wants 60% of economic growth to come from science and technology.

The latest blow to the country's image came on May 5th, when Jiaotong University uncovered a fraud committed by one of its top microelectronics researchers, Chen Jin. Dr Chen claimed to have developed the country's first home-grown microchip, capable of processing 200m instructions a second. It looked set to save China billions of dollars in imports and advance the country's own high-tech industries. But an investigation by the university found that Dr Chen had simply removed the marking from chips made by Motorola and replaced them with the logo of his company. No wonder the announcements were never followed by the sales they seemed to deserve.

Dr Chen is not alone; others have been accused of committing scientific fraud. On April 14th Sichuan University announced that it would investigate claims that its vice-president, Yuquan Wei, fabricated data in two publications on immunology. However, the following day the university cleared another senior researcher of any wrongdoing following claims that he, too, had faked data.

The researchers are the highest-profile additions to a growing list of scientists whose work has been questioned by China's unofficial science police. The most prolific of these watchdogs is Fang Zhouzi, a former biochemist who runs the New Threads website that has published hundreds of allegations of academic fraud. Although many of the claims are unsubstantiated, Dr Fang argues that the website will remain necessary until there is an official system for reporting, investigating and punishing academic misconduct.

Last week 120 Chinese scientists, mostly from American universities, called for just such a system in an open letter sent to officials, including China's science minister and the president of the Chinese Academy of Sciences. They fear that without a fair process that treats people as innocent until they are proven guilty, the reputation of Chinese scientists and Chinese science risks being damaged.

Dr Chen's fall from grace resembles that of South Korea's Hwang Woo-suk, the cloning researcher who turned from national hero to a pariah when his research was shown to be fraudulent. Like South Korea, China has feted its scientific stars, not just for their supposed laboratory achievements but also for the lustre they gave national pride.

Both countries need to learn that, to prevent the fast train derailing, research standards are as essential as research know-how.

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About sponsorship

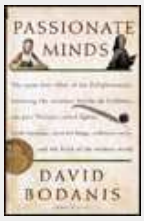
Love and the Enlightenment

The woman behind the man

May 18th 2006
From The Economist print edition

Emilie du Châtelet was a lot cleverer than her great lover, Voltaire

Passionate Minds: The Great Enlightenment Love Affair
By David Bodanis



Little Brown; 312 pages; £17.99. To be published in America by Crown in October

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Bridgeman

EVERYONE, just about, has heard something about Voltaire, and most of it is flattering. Freethinker, dramatist, poet, scientist, economist, spy, politician and successful speculator to boot, he embodies the intellectual breakthrough of the Enlightenment—the single biggest leap in mankind's understanding of itself and the world.

Almost nobody has heard of the woman with whom he shared most of his life, Emilie du Châtelet. But you can make a good case that she was a more rigorous thinker, a better writer, a more systematic scientist, a formidable mathematician, a wizard gambler, a more faithful lover and a much kinder and deeper person. And she did all this despite being born a woman in a society where female education was both scant and flimsy. Her mother feared that anything more academic than etiquette lessons would make her daughter unmarriageable.

David Bodanis's new biography of Emilie, Marquise du Châtelet, is a belated treatment of a startlingly neglected story. One reason was male chauvinism. Her best work was done at a time when women simply did not feature in the scientific mainstream: Immanuel Kant said that counting Emilie as a great thinker was as preposterous as imagining a bearded woman. Biographers were much more interested in Voltaire himself; his sexy mistress was just a sidekick. Most writers who did research Emilie were too scientifically illiterate to understand her significance. Nancy Mitford's 1957 novel, “Voltaire in Love”, is a prime example. “Mitford knew as much about science as a shrub,” notes the author scornfully. Mr Bodanis, a former academic whose previous book, “Electric Universe” has just won the 2006 Aventis prize for science writing, is well placed to appreciate the extraordinary scope and scale of her work, and leaves the reader in no doubt of it.

Born in 1706, Emilie had three pieces of great good fortune in her life. The first was to be born with a remarkable brain. Her greatest work was to translate the “Principia”, the path-breaking work on physics by the secretive Cambridge brainbox, Isaac Newton, who died when Emilie was 20. She did not just translate his writing from Latin to French; she also expressed Newton's obscure geometric proofs using the more accessible language of calculus. And she teased out of his convoluted web of theorems the crucial implications for the study of gravity and energy. That laid the foundation for the next century's discoveries in theoretical physics. The use of the square of the speed of light, c^2, in Einstein's most famous equation, $E=mc^2$ is directly traceable to her work.

Emilie's second piece of luck was that her father allowed her to use her brain: not much, admittedly, but certainly far more than most bright girls of her time and country. She was not sent to a convent. He was wealthy and liberal-minded enough to buy her books and talk to her about astronomy. He married her to Florent-Claude, Marquis du Châtelet-Lomont, who was a touch dull but decent—and unbothered by his brainy wife's intellectual and amorous adventures. Indeed, he liked and admired Voltaire.

Her third great good fortune was her array of mind-expanding, appreciative lovers. They may have been unsatisfactory mates by today's standards, but they were rarities in an age when few men looked for intellectual companionship from women. Emilie started by bedding the Duc de Richelieu, the “most sought-after man in France”. He bolstered her intellectual confidence, dented by an isolated childhood and early marriage. Even when she dumped him, they remained friends. Then came Voltaire, needy, self-indulgent, unreliable and self-centred—but still the love of her life and its great intellectual and cultural stimulus. Even when passion cooled, they remained great companions.

Finally, she fell in love with Jean-François, Marquis de Saint-Lambert, a much younger poet. He filled the emotional and physical gap left by Voltaire. But he also proved careless in what passed for contraception in those days. That led to pregnancy and the infection that killed Emilie when she was only 42.

It is tempting to speculate what heights of discovery Emilie might have achieved in a healthier and more open-minded age. But that would be to miss the point. The remarkable thing is that she managed so much, and with such good humour and reflective self-knowledge.

It is her biographer's good fortune that there is a great deal of accessible material about her life. Voltaire was spied on energetically; a thicket of secret police reports remains. So too do many of her letters, both sent and received.

The book may strike some readers as slightly lubricious in its attention to Emilie's sexual habits and predilections. A more serious shortcoming, explicable only by authorial laziness (unlikely) or publisher's stinginess (all too probable) is the startling and inconvenient lack of an index. That is just the sort of slap-happy approach to which Voltaire was prone, and which so pained Emilie.

Passionate Minds: The Great Enlightenment Love Affair.
By David Bodanis.
Little Brown; 312 pages; £17.99. To be published in America by Crown in October

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Regime change

The price of intervention

May 18th 2006
From The Economist print edition

A JUSTLY praised book, “All the Shah's Men”, by Stephen Kinzer, appeared in many lists of the best books of 2003, including one in *The Economist*. By choosing to publish that volume in the year that saw both the 50th anniversary of the American-sponsored coup in Iran and the start of the American-led invasion of Iraq, the former *New York Times* correspondent showed impeccable timing.

Mr Kinzer's latest book is no less timely. “Overthrow” is a comparative study of the dozen times since the 1890s when “Americans played the decisive role in deposing a regime”. He begins with a quotation from T.S. Eliot: “Time present and time past/ Are both perhaps present in time future,/And time future contained in time past”—a sign that he hopes once again to merge historical and contemporary political insight. On this occasion, however, his efforts enjoy only mixed success.

Overthrow: America's Century of Regime Change from Hawaii to Iraq
By Stephen Kinzer

Times Books; 384 pages; $27.50

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The concept is certainly a courageous one, and the author deserves praise for bringing such disparate case studies together. Although Mr Kinzer does not provide a great deal of fresh primary research, his willingness to assess a century's worth of cases side by side reveals the extent of the sad similarities between them. Again and again, Mr Kinzer shows the complex interaction between economic interests, media fervour, political idealism and racism that so often combined to inspire an eagerness to invade.

His summaries of some of the older cases—the invasion of Cuba in 1898, for instance—are particularly gripping. Mr Kinzer has an ear for a telling quotation. One of the repeated justifications for intervention was to promote a safe and stable environment for business. In 1900 the new American governor of Cuba, General Leonard Wood, summarised this view in a report to President McKinley: “When people ask me what I mean by stable government, I tell them, ‘Money at six per cent.’”

While this zoom-lens focus on individual cases reveals much rich detail, the reader is left wishing that the author had sometimes pulled back, capturing more of the bigger picture. Mr Kinzer's work is solid, but he does not signal the difference between those chapters that contain settled opinion and those where controversy still rages. Nor is there much in the way of continuity between the chapters. The jump from Nicaragua in 1910 to Iran in 1953—with only scant mention of the first and second world wars in between—is particularly jarring.

Mr Kinzer's account favours the periphery too heavily over the centre, resulting in an imbalance between the detail provided and the conclusions drawn from it. The book's numerous narrative chapters are model case studies of how regimes are overthrown in the short term. Yet the interpretative chapters attempt a long-term summary of why this happens, and what the consequences are, with the ground still insufficiently prepared.

Therein lies a missed opportunity, one that was seized more successfully earlier this year by Odd Arne Westad, a Norwegian-born professor now at the London School of Economics, whose recent book, “The Global Cold War” won Columbia University's prestigious Bancroft prize in history. Mr Kinzer shows the damage that military overthrow wrought on its victims, but Mr Westad also shows the cost to the perpetrators. As Mr Westad puts it, if there is one big lesson from the history of American and Russian armed action in the third world, “it is that unilateral military intervention does not work to anyone's advantage”.

“Overthrow” will enjoy a wider circulation than Mr Westad's more academic text, so it is a pity that Mr Kinzer did not push his analysis further into this territory. Even so, the terrain that he has covered is well worth visiting.

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By Stephen Kinzer.
Times Books; 384 pages; $27.50

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About sponsorship

British theatre

Crosspatch

May 18th 2006
From The Economist print edition

JOHN OSBORNE'S life was one long melodrama. His sister died when he was an infant; his father died when he was ten; his mother, a barmaid, did not love him. He said he hated her, and ignored her funeral. Osborne's first wife left him; his second wife, divorced, died of an accidental overdose; his third wife, also divorced, died of alcoholism; his fourth wife committed suicide after their divorce. He and his fifth wife did love each other, but when he died, aged 65, he thought he was a theatrical reject. He was also bankrupt.

Osborne's tumultuous, self-destructive life became his work, starting with “Look Back in Anger”, which was first performed at the Royal Court Theatre in London 50 years ago this month. Although it took the form of a formal, old-fashioned play, it dealt harshly with the theatrical convention of the time. Jimmy Porter, its leading man, was contemptuous of the British class system and what lingered of the British Empire. His was a vivid new voice, an angry young man looking back with distaste on what he regarded as an emotional wasteland. The excitement his fresh approach created set the scene for a new generation of playwrights such as Arnold Wesker and David Hare.

John Osborne: A Patriot for Us
By John Heilpern

Chatto and Windus; 528 pages; £25.00

Buy it at
Amazon.co.uk

Osborne then wrote “The Entertainer”, and the role of Archie Rice, a wonderful, melancholy music-hall turn, revived the acting career of Laurence Olivier in the late 1950s. “Inadmissible Evidence” inspired a compelling performance of the implosion of a middle-aged lawyer from a young actor called Nicol Williamson. There were more plays, but the flame burned less brightly than for these three. He did, however, write two volumes of devastating autobiography.

Osborne was a flamboyant figure, fuelled by champagne, driven in a Rolls-Royce to grand houses in town and country. He could be charming and generous, but the deep, explosive anger which infused his best writing never left him. He believed he was constantly betrayed, persecuted by his friends as well as by his enemies. Osborne could be unforgivably vile. He wrote to his daughter, Nolan, when he threw her, aged 17, out of his house: “Don't underestimate my resolve or anger. I see you lying, cheating, dissembling, stealing daily. It is not a spectacle I wish to watch any longer.” No one, even now, should underestimate the depths of the Osborne ire.

John Heilpern, an English critic who lives in New York, was chosen by Osborne's fifth wife Helen—the sanest of them all, and the only one who took his name. Although this is an authorised biography, Mr Heilpern does not write as if to know all is to forgive all. The subject is there, warts and all: the charm and laughter as well as the drunken boorishness. There are occasions when Osborne's anger so completely undermines his self-interest that Mr Heilpern can only shrug his authorial shoulders.

Mr Heilpern has warts of his own. No stone is unturned, though some might usefully have been ignored. Others might have been examined more closely: Dick Sheppard, who christened Osborne's sister, for example, was not a famous cricketer, as the book says, but a famous preacher. A genial presence through the book, Mr Heilpern might have been helped by a good editor, who could have eliminated the factual errors, repetitions and spelling mistakes, and shortened a long story.

John Osborne: A Patriot for Us.
By John Heilpern.
Chatto and Windus; 528 pages; £25.00

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About sponsorship

China, past and present

Sifting the sediments

May 18th 2006
From The Economist print edition

EVENTS in China, says Peter Hessler, are like splashes of foam on the surface of a great sea change. Even the significance of happenings that were hugely important at the time—the Tiananmen Square massacre of 1989, for example, or the angry anti-American protests after the bombing of the Chinese embassy in Belgrade in 1999—seems to become less certain over time. So how to understand things? Luckily for his readers, Mr Hessler, a former Peace Corps volunteer teacher and now Beijing correspondent of the *New Yorker*, has stepped off the treadmill of events-driven journalism to produce one of the most profoundly original books about China since, well, since his first book, "River Town", which came out in 2001.

"Oracle Bones" is woven from the lives of a small handful of admirable characters: three former students from Mr Hessler's two years of teaching English in the small town high up the Yangzi river that formed the subject of "River Town", and a Uighur intellectual and former teacher from western China with the pseudonym of Polat ("steel" in his native tongue) whom the author befriends in Beijing. In their different ways, the characters are all forced to make good in a shifting new world of hucksters and shysters.

Oracle Bones: A Journey Between China's Past and Present
By Peter Hessler

HarperCollins; 512 pages; $26.95. John Murray; £20

Buy it at
Amazon.com
Amazon.co.uk

The bright students from provincial Sichuan gamble their future and all its dreams on the east coast, along with tens of millions of other inland migrants. To head east in China is to cut yourself loose from all your moorings, and the experiences are often harsh. But at a personal level they are also liberating—a new idea in China. It helps, of course, to have that Chinese humour that is both bright and black in parts. Polat is a man on the fringes of life. Politically persecuted by the majority Han Chinese in his homeland in Xinjiang, he makes his living playing the margins at Yabaolu, Beijing's wholesale market that sells knock-off goods to hard-faced Russians. Polat looks at his fate—a *jiade* (fake, crap) life dealing in *jiade* goods—with wry self-detachment.

The essential fabric of the book is pinned down by vertical stakes: interspersed chapters that go deep into China's past—and literally underground, to the oracle bones on which China's earliest-known writing was found. The structure makes sense. Language and recorded memory are still vital weapons of political power in China, as they were 3,000 years ago. Just as China's rush to modernity seems to reflect an urge to break free from the heavy sediments of history, so the bulldozers and pickaxes of development uncover ever more of China's past. Strangely, the more that is unearthed, the less monolithic and more multi-faceted appears to be China's past, just like its present.

The past century of political upheaval was fought as much over ancient history as contemporary events, and the author goes to considerable effort to try and uncover what happened to some of the victims. Getting to the bottom of why the humane Chen Mengjia—a poet, oracle-bone scholar and spirited opponent of the Communists' simplification of the writing system—killed himself in 1966 takes Mr Hessler from the wastes of the central China plain to a nursing home in Virginia, where he meets a twinkling Chinese intellectual, a friend of Chen's, who suffered even more from political purges but now writes reviews for Voice of America. Everywhere, the book is shot through with sensitivity, insight and rollicking good humour too.

Oracle Bones: A Journey Between China's Past and Present.
By Peter Hessler.
HarperCollins; 512 pages; $26.95. John Murray; £20

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New fiction

The end is nigh

May 18th 2006
From The Economist print edition

AGED 73, Philip Roth is understandably absorbed with death. Yet in his appealingly modest 27th novel, “Everyman”, Mr Roth is more concerned with what usually precedes it: the humiliating rebellions of the body, that insidious conversion of lifelong friend to foe.

This is a big subject for a small book. Everyman is, for Mr Roth, a deliberately stock character: a Jew from New Jersey with three failed marriages, two of whose three children despise him. But the protagonist's relationship with his family is overshadowed by an even more fraught relationship with his own body, beginning with a hernia operation when he was only nine years old. As Everyman ages, submitting to seven operations for cardiac problems in as many years, his beloved older brother becomes the object of jealous loathing for remaining so infuriatingly healthy.

Everyman
By Philip Roth

Houghton Mifflin; 182 pages; $24. Jonathan Cape; £10

Buy it at
Amazon.com
Amazon.co.uk

Couched only as “he”—a device that in the hands of lesser writers would grow stilted, but one that a master pulls off with grace—the protagonist is so fully fleshed that this tiny volume bursts at the seams. A commercial ad-agency artist, he has retired to paint, but has latterly despaired of an “irreversible aesthetic vasectomy” and has hung up his brushes. Thus under-occupied on the New Jersey shore, he is left with horrible leisure to contemplate his resentful sons, the wasted opportunity of his second marriage, and other altogether too literal failures of heart.

What is burden to Everyman is opportunity for Mr Roth. Poignantly, the man admits to having anticipated a second wind on the other side of his medical travails. “But now it appeared that, like any number of the elderly, he was in the process of becoming less and less and would have to see his aimless days through to the end as no more than what he was—the aimless days and the uncertain nights and the impotently putting up with the physical deterioration and the terminal sadness and the waiting and waiting for nothing.”

Unexpectedly moving and written in an invitingly easy story-telling style, “Everyman” is a lovely little book.

Everyman.
By Philip Roth.
Houghton Mifflin; 182 pages; $24. Jonathan Cape; £10

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About sponsorship

Independent films

Satire, a star and a schoolboy shamus

May 18th 2006
From The Economist print edition

Three independent film-makers offer a respite from summer stuff

DEFINING “independent films” is not easy. Small films? Films that première at Robert Redford's Sundance Festival? Films made outside the studio system? That covers most indies, but an alternative answer is to take a look at three recent releases, none of which would have been made by the feature-film division of a major studio. All three have emerged from the obligatory bow at Sundance to go head-to-head with Hollywood's summer fare. They are not contending for the box-office top ten, but they offer a welcome diversion from the silly season at the cineplex.

The stiff in the water

The blissfully indecorous “Thank You for Smoking” would have had major studios blinking in disbelief. Directed by Jason Reitman (son of Ghostbusting Ivan) from his own screenplay, it is based on a novel by Christopher Buckley (son of liberal-busting Bill). Aaron Eckhart plays Nick Naylor, head lobbyist for the tobacco industry. A yuppie Jimmy Stewart, Nick is proud to be the most despised man in America. He and his only friends, a liquor lobbyist and a gun lobbyist, call themselves “The Merchants of Death” and argue over lunch about whose product is the most deadly.

Like his protagonist, Mr Reitman relishes a tough sell, and at first glance Nick looks like an impossible one. What wins the audience over is not just his love for his sceptical son (Cameron Bright), but the fact that Nick, strangely, always tells the truth. That quality is a disservice when he lets himself be seduced by a muckraking reporter (Katie Holmes), but it carries the day when he testifies before a committee chaired by a senator who wants to put the skull-and-crossbones on cigarette packages. “Why bother”, Nick asks unanswerably, “when everyone knows that these things kill you?” Billy Wilder is gone, but his spirit lives on in this hilarious libertarian satire on the culture of spin.

Nicole Holofcener's “Friends with Money” displays another unmistakable mark of an independent film: the presence in the cast of a big star playing a more complex character than she is usually asked to tackle when paid her normal salary. The four heroines of “Friends with Money” are all rich and married with children except for Olivia (Jennifer Aniston), a midlife drop-out who is currently working as a maid, to the embarrassment of her best friends, Jane, Franny and Christine (played by three indie icons: Frances McDormand, Joan Cusack and Catherine Keener). Through many small miracles of acting, writing and direction, we see the friends' happiness start to unravel as Olivia blunders her way to a Cinderella ending—something of a foregone conclusion for someone as delightful as Ms Aniston, the only member of the cast whose personal bodyguard is listed in the credits.

This predestination through casting allows Ms Holofcener to concentrate on her real interest, which is ethics. The moral issues uncovered in every scene range from the central one—how should the privileged treat the poor—to the acceptability or otherwise of gossiping about friends, building an extension that blocks the neighbours' view, overreacting when someone takes your parking space, or stealing an employer's expensive face-cream (perfectly permissible if you use it on your feet). To revive the almost forgotten tradition of thoughtful big-screen comedy, Ms Holofcener has assembled a dream cast, the men as well as the women.

But the film-making debut of the season is “Brick”, a daring and assured film written and directed by Rian Johnson. It is a hardboiled detective story set in an affluent Californian high school where everyone speaks a wonderful mixture of teen slang and 70-year-old pulp lingo. The recurring high-school phrase “Who are you eating with?” conveys life-and-death messages. And nobody has ever devised so many new ways of saying, “Get off the case, shamus.”

The shamus is Brendan (Joseph Gordon-Levitt), whose search for his ex-girl-friend's killer leads him into a romance with a *femme fatale* (Nora Zehetner) and an ambiguous friendship with The Pin (Lukas Haas), a local drug-lord who reads Tolkien and lives with his mother. Mr Johnson brilliantly plays out the weird mixture of school and crime. The school's vice-principal (Richard Roundtree) menaces the hero like a cop grilling a smart-alecky gumshoe, and the distant sounds of cheer-leaders are heard as Brendan is pursued through the schoolyard by a knife-wielding goon.

“Brick” is such an original affair that one suspects the film-maker of concocting this offbeat blend of genre and milieu to give spectators two familiar reference points as they explore a brand-new cinematic universe. The first appearance of this uncompromisingly individual vision—unimaginable as a studio production—may even turn out to be what audiences remember most about this summer.

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About sponsorship

Alexander Zinoviev

May 18th 2006
From The Economist print edition

Alexander Zinoviev, an eternal dissident, died on May 10th, aged 83

DURING the cold war, dissidents were front-line troops in the battle of wills and ideas. Despised and persecuted by the Communist regimes of the Soviet empire, they were idealised in the West. When they emigrated, they were idolised.

It is convenient, but too crude, to assume that anti-Soviet sentiments automatically meant pro-Western ones. Although some dissidents found material and mental well-being in exile, others were horrified by the decadence and cynicism they found. Alexander Solzhenitsyn was one of the outspoken disillusioned. Another was Alexander Zinoviev.

A decorated wartime pilot and distinguished mathematical logician, Mr Zinoviev could have enjoyed a quiet and privileged life in the Soviet Union. But he became a fearless and scathing critic of his country's Brezhnevite senescence. He was already in near-disgrace by the time his greatest work, “The Yawning Heights”, was published in Switzerland in 1976. It parodied, with flashes of Swiftian brilliance, the inhabitants of a fictional Soviet city, Ibansk (roughly, in Russian, “Fucktown”). Ruled by nonentities and suffused with boredom and mediocrity, Ibansk embodied the mind-rotting stagnation of life in the Soviet provinces.

The Soviet authorities were perplexed. To jail Mr Zinoviev would acknowledge that this satire was not wholly fanciful; to ignore him would look weak. So they stripped him of his medals and academic positions. Two years later, he was encouraged to emigrate. He went to Munich, then a centre of émigré dissident life.

He loathed it. His next book, “Homo Sovieticus” (1985), was acclaimed for its dissection of the Soviet mindset. Today, it seems still more savage in its assault on the pampered, hypocritical West. “It's only among us Soviet people that defenders of the West's ideals can be found,” Mr Zinoviev wrote.

Even more disappointing to him, austere and idealistic as he was, were the self-important and subsidised marionettes of the émigré world. He had got away from the “swamp of the idiocies, vulgarities and lies that is Soviet ideology, only to be forced to plunge head first into the even more idiotic, vulgar and lying marsh of anti-Sovietism.”

That was a bit harsh. Not all Western support was self-interested, rejoicing at the discomfiture of the Soviet enemy; some Westerners genuinely desired Russia to be free. But when, eventually, those freedoms came, Mr Zinoviev was still not happy. He loathed Mikhail Gorbachev's half-baked *perestroika* reforms, parodying them in another book, “Katastroika”. He detested Boris Yeltsin, the first president of post-Soviet Russia, seeing him as a pawn of the cold war's vainglorious victors.

Even before he returned to live in Moscow in 1999, he took up causes that mystified his fans and delighted nostalgic communists. He strongly supported Serbia against what he saw as Western aggression, and later became a leading member of an outfit set up to champion its leader, Slobodan Milosevic, against war-crimes charges. He became an increasingly ardent defender of the Soviet Union. Stalin had rightly punished him for “terrorism”, he said. Brezhnev was too soft on dissidents. His individualism found Western conformism worse than Soviet collectivism.

He scorned Vladimir Putin's Russia, describing it last September as a “hybrid, a hare with horns”. Its ingredients, he said, were “hidden Sovietism, elements of Western values and the retarded feudalism of the Russian Orthodox church.”

Progressive regression

Mr Zinoviev's contrarian approach, cynical and idealistic by turns, reflected one school of the Russian intelligentsia. By contrast, Mr Solzhenitsyn, another ex-émigré, though no fan of either the West or modern Russia, has remained staunchly pro-clerical and patriotic. But Mr Zinoviev's émigré counterparts still found his intellectual journey fascinating. Dmitry Mikheyev, a former political prisoner and physicist turned teacher of Western-style leadership to Moscow businessmen, compared him to a character in a Dostoevsky novel: “someone not entirely sane and rather idealistic, sensitive, emotional, full of contradictions.”

His intellectual mischief-making may have been tasteless, but it was not rancorous; there was a playful, good-humoured streak. Vladimir Bukovsky, a consistently anti-communist dissident settled in Cambridge, once asked him why, to the dismay of his friends, he was suddenly defending Stalin. “Anyone can attack Stalin,” Mr Zinoviev replied. “It's more interesting to find arguments in favour of him; without Stalin, my family would still be peasants.” Mr Bukovsky countered that the victims of Stalin's purges seemed a high price to pay for the Zinoviev family's elevation; Mr Zinoviev assented with good grace.

Mapping his intellectual journey was complicated by his delight in misleading gullible Westerners. In his teenage years, he claimed, he had been sent to Siberia (fresh from being top of the class at the Moscow Institute of Philosophy, Literature and History) for plotting to kill Stalin. According to one of his oldest friends, this tale was pure invention. Mr Zinoviev was “a brilliant mystifier”. That applied to his views and his life alike.

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Overview

May 18th 2006
From The Economist print edition

Financial markets succumbed to sudden edginess. The Morgan Stanley All Country World Index, a measure of global stockmarkets, fell by 5.3% from record highs. Bonds also slipped, pushing the yield on ten-year Treasuries above 5.15%. Commodities, such as copper and zinc, fell sharply this week, as did **oil**. After news of higher petrol stocks in America, the price of a barrel of West Texas Intermediate **crude oil** fell below $68.50.

The markets found little comfort in America's **inflation** figures, which showed that core consumer prices, excluding food and energy, rose by 2.3% in the year to April—testing the Federal Reserve's tolerance.

America's **housing market** continues to slow. The pace of construction of new houses dropped by 7.4% in April, according to the Census Bureau. Confidence in the industry is at its lowest ebb since 1995, according to the National Association of Home Builders.

In the **euro area** industrial production rose by 0.4% in March, contributing to a 12-month increase of 3.8%.

Japan's producer prices rose by 2.5% in the year to April. But core orders for machinery (excluding orders for ships and from electricity companies) fell by 5.2% in March.

In **Britain** industrial production grew by 0.8% in the first quarter of 2006. Annual inflation rose to 2% in April, and unemployment edged up to 5.2% in the first quarter.

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Output, demand and jobs

May 18th 2006
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2006	2007	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 2.7	Q4	+ 1.9	+ 3.2	+ 3.4	+ 0.6	Q4	+ 2.7	Q1	5.1	Apr	5.1
Austria	+ 2.8	Q1	+ 2.0	+ 2.2	+ 1.9	+ 6.3	Feb	+ 2.4	Feb	4.8	Apr	5.1
Belgium	+ 2.2	Q1	+ 3.2	+ 2.2	+ 1.9	+ 7.1	Mar	– 1.9	Feb	12.1	Apr†	12.3
Britain	+ 2.2	Q1	+ 2.6	+ 2.4	+ 2.5	+ 0.3	Mar	+ 2.6	Mar	5.2	Mar‡	4.7
Canada	+ 2.9	Q4	+ 2.5	+ 3.1	+ 2.8	+ 1.4	Feb	+ 3.0	Feb	6.4	Apr	6.8
Denmark	+ 3.3	Q4	– 0.1	+ 2.8	+ 2.2	+ 7.1	Mar	+ 5.4	Mar	4.8	Mar	6.0
France	+ 1.5	Q4	+ 1.4	+ 2.0	+ 2.0	+ 1.9	Mar	+ 1.6	Mar	9.5	Mar	10.1
Germany	+ 1.4	Q1	+ 1.6	+ 1.8	+ 1.2	+ 3.9	Mar	– 1.2	Mar	11.3	Apr§	11.9
Italy	+ 1.5	Q1	+ 2.4	+ 1.2	+ 1.1	+ 4.2	Mar	+ 0.1	Feb	7.7	Dec	7.9
Japan	+ 4.0	Q4	+ 5.4	+ 3.0	+ 2.4	+ 3.1	Mar	– 0.2	Feb	4.1	Mar	4.5
Netherlands	+ 2.9	Q1	+ 0.7	+ 2.5	+ 2.0	+ 2.3	Mar	+ 4.6	Feb	5.7	Apr††	6.7
Spain	+ 3.5	Q1	+ 3.2	+ 3.2	+ 2.8	+10.9	Mar	+ 1.2	Mar	8.7	Mar	9.9
Sweden	+ 2.9	Q4	+ 2.6	+ 3.4	+ 2.8	+ 0.4	Mar	+ 5.1	Mar	5.5	Mar†	6.0
Switzerland	+ 2.7	Q4	+ 2.1	+ 2.3	+ 1.8	+ 3.9	Q4	+ 0.4	Feb	3.5	Apr†	3.8
United States	+ 3.5	Q1	+ 4.8	+ 3.4	+ 2.8	+ 4.7	Apr	+ 6.2	Mar	4.7	Apr	5.1
Euro area	+ 2.0	Q1	+ 2.4	+ 2.1	+ 1.7	+ 3.8	Mar	– 0.2	Mar	8.1	Mar	8.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 2.8	Q1	+ 1.6	na	na	+ 3.7	Mar	+ 6.2	Mar	7.9	Mar	8.3
Greece	+ 4.1	Q1	na	na	na	+ 1.7	Mar	+ 5.9	Feb	9.7	Q4	10.4
Iceland	+ 3.6	Q4	na	na	na	na		na		1.6	Feb†	2.8
Ireland	+ 5.7	Q4	+ 7.6	na	na	+ 1.8	Mar	+ 6.0	Feb	4.5	Apr	4.3
Luxembourg	+ 5.7	Q4	na	na	na	+ 6.3	Feb	+ 7.6	Mar	4.6	Mar	4.1
New Zealand	+ 1.9	Q4	nil	na	na	– 2.9	Q4	+ 3.0	Q1	3.9	Q1	3.9
Norway	+ 2.5	Q4	+ 1.0	na	na	+ 1.6	Mar	+ 7.7	Mar	3.9	Mar**	4.6
Portugal	+ 0.7	Q4	+ 0.4	na	na	+ 4.8	Mar	– 0.1	Mar	8.0	Q4†	7.1

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡Jan-Mar; claimant count rate 3.0% in Apr. §EU harmonised rate 8.7% in Mar. ††Feb-Apr. **Jan-Mar.

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Prices and wages

May 18th 2006
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2006	2007	latest		year ago	latest		year ago
Australia	+ 3.0	Q1	+ 2.4	+ 2.9	+ 2.7	+ 7.9	Q1	+ 6.0	+ 4.0	Q1	+ 4.5
Austria	+ 1.8	Apr	+ 2.6	+ 1.8	+ 1.8	+ 2.4	Apr	+ 2.6	+ 2.7	Mar	+ 2.2
Belgium	+ 2.0	Apr	+ 2.8	+ 2.1	+ 1.8	+ 4.1	Mar	+ 3.8	+ 2.3	Oct	+ 2.4
Britain	+ 2.0	Apr*	+ 1.9	+ 2.0	+ 1.9	+ 2.4	Apr	+ 3.3	+ 4.2	Mar†	+ 4.5
Canada	+ 2.2	Mar	+ 2.3	+ 2.2	+ 2.1	+ 1.1	Mar	+ 2.6	+ 0.8	Feb	+ 2.8
Denmark	+ 1.8	Apr	+ 1.8	+ 1.9	+ 1.9	+ 5.0	Apr	+ 3.8	+ 2.9	Q4	+ 2.9
France	+ 1.7	Apr	+ 1.8	+ 1.8	+ 1.5	+ 3.3	Mar	+ 3.2	+ 3.3	Q1	+ 2.9
Germany	+ 2.0	Apr	+ 1.6	+ 1.6	+ 2.3	+ 3.2	Apr	+ 3.2	+ 1.5	Feb	+ 1.2
Italy	+ 2.2	Apr	+ 1.9	+ 2.1	+ 1.8	+ 4.5	Mar	+ 4.8	+ 2.7	Mar	+ 3.5
Japan	+ 0.3	Mar	– 0.2	+ 0.4	+ 0.6	+ 2.5	Apr	+ 1.9	– 0.6	Mar	+ 1.3
Netherlands	+ 1.2	Apr	+ 1.5	+ 1.5	+ 1.5	+ 4.9	Mar	+ 5.3	+ 1.8	Apr	+ 0.5
Spain	+ 3.9	Apr	+ 3.5	+ 3.5	+ 2.9	+ 5.8	Mar	+ 5.1	+ 2.5	Q4	+ 2.7
Sweden	+ 1.5	Apr	+ 0.3	+ 1.2	+ 1.8	+ 5.1	Mar	+ 2.5	+ 2.8	Feb	+ 2.7
Switzerland	+ 1.1	Apr	+ 1.4	+ 1.1	+ 1.2	+ 1.6	Mar	+ 1.4	+ 1.0	2005	+ 0.9
United States	+ 3.5	Apr	+ 3.5	+ 3.1	+ 2.4	+ 4.0	Apr	+ 4.8	+ 3.8	Apr	+ 2.7
Euro area	+ 2.4	Apr	+ 2.1	+ 2.0	+ 2.0	+ 5.3	Mar	+ 4.2	+ 2.4	Q4	+ 2.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.3	Apr	+ 1.2	na	na	+ 6.1	Apr	+ 3.1	+ 3.5	Q4	+ 4.3
Greece	+ 3.3	Apr	+ 3.4	na	na	+ 7.8	Mar	+ 4.7	na		na
Iceland	+ 7.6	May	+ 2.9	na	na	+ 5.3	Apr	+ 6.6	+ 8.6	Mar	+ 6.5
Ireland	+ 3.8	Apr	+ 2.2	na	na	+ 3.6	Mar	– 2.3	+ 3.8	Q4	+ 4.6
Luxembourg	+ 2.9	Apr	+ 2.5	na	na	+ 3.9	Feb	+17.7	+ 5.6	Feb	+ 0.4
New Zealand	+ 3.3	Q1	+ 2.8	na	na	+ 7.2	Q1	+ 4.2	+ 3.3	Q1	+ 2.5
Norway	+ 2.7	Apr	+ 1.3	na	na	+20.6	Apr	+17.5	+ 3.1	Q4	+ 3.9
Portugal	+ 2.9	Apr	+ 2.1	na	na	+ 5.4	Mar	+ 4.6	+ 1.1	Mar	– 3.9

*RPI inflation rate 2.6% in Apr. †Jan-Mar.

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Denmark

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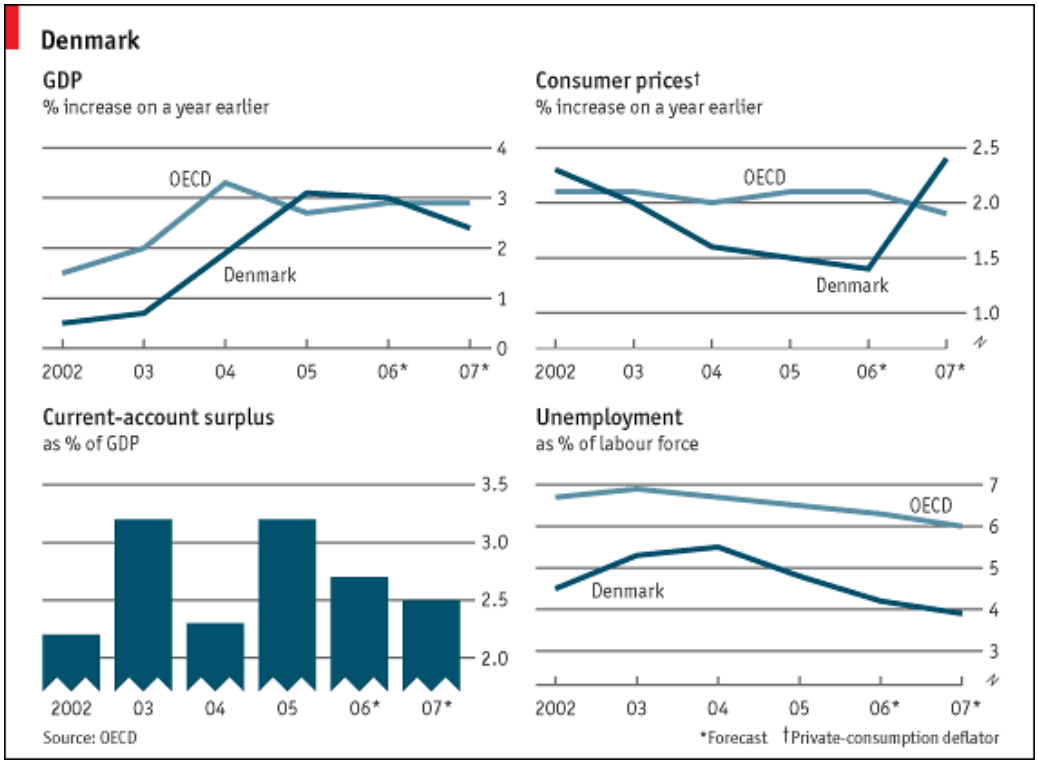
From The Economist print edition



In the past year the economy has supplied a combination of strong growth and subdued inflation. However, if GDP expands by 3% in 2006, as forecast, output will rise above capacity, adding to inflationary pressures. With the exchange rate fixed tightly to the euro, Danish interest rates are, in effect, set by the European Central Bank. At present, these are too low to restrain demand, which is why Denmark should maintain its tight fiscal policy. In the long run, trend growth—now a bit less than 2% a year—will decline as the labour force shrinks because of an ageing population. To combat this slowdown, the OECD has called for reform. Students should attend university without taking time off and study for shorter periods so that they start work earlier. The early-retirement scheme should be abolished so that older workers stay in the labour market longer.

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About sponsorship

Money and interest rates

May 18th 2006
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (May 17th 2006)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+10.4	+ 9.1	Mar	5.83	5.67	5.67	5.76	5.28	6.79
Britain	+ 6.7	+12.3	Mar	4.67	4.81	4.78	4.69	4.34	5.11
Canada	+11.7	+ 6.8	Mar	4.08	2.45	4.08	4.42	4.08	5.61
Denmark	+18.3	+16.9	Mar	2.95	2.18	3.46	4.06	3.31	5.38
Japan	+ 5.1	+ 1.7	Apr	0.09	0.02	0.77	1.93	1.28	2.05
Sweden	- 0.5	+10.9	Mar	2.11	1.85	2.94	3.91	3.23	3.66
Switzerland	+ 3.1	+ 4.6	Apr	1.40	0.75	1.89	2.76	2.03	2.69
United States	+ 1.9	+ 4.9	Apr‡	5.13	3.17	4.95	5.17	4.09	6.11
Euro area†	+10.1	+ 8.6	Mar	2.88	2.13	3.27	4.02	3.25	4.49

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. ‡New series for broad money supply. Benchmarks: US 30-year 5.27%, Japan No. 279 1.91%. Central bank rates: US fed funds 5.00%, ECB refinancing 2.50%, BOJ overnight call 0.001%, BOE repo 4.5%. Sources:Bank of Canada, Commerzbank, Danske Bank, Global Insight, JPMorgan Chase, Stockholmsbörsen, UBS, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

May 18th 2006
From The Economist print edition

2000=100

	May 9th	May 16th*	% change on one month	% change on one year
Dollar index				
All items	178.1	182.2	+ 9.3	+ 40.4
Food	137.4	139.7	+ 3.4	+ 11.4
Industrials				
All	230.8	237.2	+14.4	+ 75.0
Nfa†	153.0	156.7	+ 5.0	+ 22.5
Metals	273.2	281.1	+17.5	+101.2
Sterling index				
All items	145.0	146.5	+ 3.1	+ 36.9
Euro index				
All items	128.7	131.1	+ 4.5	+ 38.0
Yen index				
All items	182.8	186.1	+ 2.3	+ 44.1
Gold				
$ per oz	696.25	689.00	+11.8	+ 63.8
West Texas Intermediate				
$ per barrel	70.56	69.28	- 2.8	+ 41.6

*Provisional. †Non-food agriculturals.

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Stockmarkets

May 18th 2006
From The Economist print edition

Market indices

	May 17th	2006 high	2006 low	% change on one week	% change on record high	% change on Dec 30th 2005 in local currency	% change on Dec 30th 2005 in $ terms
Australia (All Ordinaries)	5,172.1	5,318.2	4,708.8	– 2.5	– 2.7	+ 9.8	+14.3
Austria (ATX)	3,907.5	4,344.4	3,682.4	– 9.0	– 10.1	+ 6.6	+15.5
Belgium (Bel 20)	3,691.7	3,987.3	3,573.9	– 6.9	– 7.4	+ 4.0	+12.8
Britain (FTSE 100)	5,675.5	6,132.7	5,618.8	– 6.7	– 18.1	+ 1.0	+11.0
Canada (Toronto Composite)	11,640.6	12,487.3	11,272.3	– 5.5	– 6.8	+ 3.3	+ 8.8
Denmark (OMXCB)	364.3	395.5	362.0	– 6.8	– 7.9	– 1.0	+ 7.4
France (SBF 250)	3,474.2	3,755.6	3,327.6	– 7.0	– 20.9	+ 5.2	+14.1
France (CAC 40)	4,920.3	5,312.2	4,748.3	– 6.8	– 28.9	+ 4.3	+13.1
Germany (DAX)*	5,652.7	6,140.7	5,334.3	– 7.6	– 29.9	+ 4.5	+13.3
Italy (S&P/MIB)	36,471.0	38,765.0	35,652.0	– 5.6	– 27.2	+ 2.1	+10.7
Japan (Nikkei 225)	16,307.7	17,563.4	15,341.2	– 3.8	– 58.1	+ 1.2	+ 8.8
Japan (Topix)	1,657.1	1,783.7	1,572.1	– 3.9	– 42.6	+ 0.4	+ 8.0
Netherlands (AEX)	436.5	478.0	431.5	– 6.9	– 37.8	– 0.1	+ 8.3
Spain (Madrid SE)	1,227.8	1,318.5	1,156.8	– 6.8	– 6.9	+ 6.2	+15.1
Sweden (Affarsvarlden Gen)	301.7	333.7	287.3	– 8.7	– 24.6	+ 2.8	+11.7
Switzerland (Swiss Market)	7,658.5	8,122.1	7,583.9	– 5.6	– 9.0	+ 1.0	+ 9.8
United States (DJIA)	11,205.6	11,642.7	10,667.4	– 3.8	– 4.4	+ 4.6	+ 4.6
United States (S&P 500)	1,270.3	1,325.8	1,248.3	– 4.0	– 16.8	+ 1.8	+ 1.8
United States (NASDAQ Comp)	2,195.8	2,370.9	2,195.8	– 5.4	– 56.5	– 0.4	– 0.4
Europe (FTSEurofirst 300)†	1,310.0	1,405.6	1,277.1	– 6.2	– 23.2	+ 2.7	+11.3
Euro area (FTSE Euro 100)†	1,111.0	1,198.7	1,078.9	– 6.8	– 28.3	+ 2.0	+10.6
World (MSCI)‡	1,336.2	1,406.3	1,259.1	– 4.7	– 7.8	+ 6.2	+ 6.2
World bond market (Citigroup)††	643.8	646.1	612.1	+ 0.2	– 3.4	+ 3.8	+ 3.8

*Total return index. †In euro terms. ‡Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms. ††Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

May 18th 2006
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current-account balance $bn latest 12 mths		The Economist poll % of GDP, forecast 2006	2007	Exchange rate trade-weighted† 2000=100 May 17th	year ago	Currency units per $ May 17th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2005‡
Australia	− 12.4	Mar	− 42.1	Q4	− 5.6	− 5.1	116.6	114.5	1.29	1.32	2.40	1.65	1.17	+ 1.0
Austria	− 2.0	Feb	+ 0.5	Dec	+ 0.1	+ 0.1	105.0§	106.0	0.78	0.79	1.46	–	0.71	− 2.0
Belgium	+ 11.1	Mar	+ 6.6	Dec	+ 2.0	+ 2.1	106.7§	108.0	0.78	0.79	1.46	–	0.71	nil
Britain	−123.0	Mar	− 57.4	Q4	− 2.6	− 2.6	101.1	99.4	0.54	0.55	–	0.69	0.49	− 3.1
Canada	+ 59.7	Mar	+ 25.2	Q4	+ 2.3	+ 1.7	129.4	113.8	1.10	1.26	2.06	1.41	1.00	+ 1.3
Denmark	+ 8.9	Mar	+ 6.1	Mar	+ 2.5	+ 2.3	106.3	106.3	5.83	5.89	10.9	7.46	5.27	+ 2.8
France	− 28.8	Mar	− 43.5	Feb	− 1.8	− 1.6	107.4§	108.9	0.78	0.79	1.46	–	0.71	− 3.2
Germany	+191.5	Mar	+108.4	Mar	+ 3.8	+ 4.0	108.8§	110.5	0.78	0.79	1.46	–	0.71	− 3.9
Italy	− 17.6	Mar	− 28.5	Feb	− 1.6	− 1.5	107.0§	108.4	0.78	0.79	1.46	–	0.71	− 4.3
Japan	+ 84.7	Mar	+166.7	Mar	+ 3.7	+ 3.5	85.1	88.1	111	107	206	142	–	− 6.5
Netherlands	+ 39.5	Mar	+ 39.8	Q4	+ 5.7	+ 5.7	107.5§	108.8	0.78	0.79	1.46	–	0.71	− 1.6
Spain	− 98.8	Feb	− 82.3	Jan	− 7.0	− 6.9	105.3§	106.2	0.78	0.79	1.46	–	0.71	+ 0.3
Sweden	+ 19.3	Mar	+ 21.8	Q4	+ 6.4	+ 6.0	96.3	98.3	7.29	7.28	13.6	9.33	6.59	+ 1.2
Switzerland	+ 7.3	Mar	+ 50.2	Q4	+13.1	+12.4	107.2	107.5	1.22	1.22	2.27	1.56	1.10	− 1.6
United States	−806.1	Mar	−804.9	Q4	− 6.8	− 6.7	81.7	84.3	–	–	1.86	1.28	0.90	− 3.7
Euro area	+ 10.8	Feb	− 39.1	Feb	− 0.3	− 0.1	117.6	117.3	0.78	0.79	1.46	–	0.71	− 2.9
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 9.4	Mar	+ 3.8	Mar	na	na	108.3§	109.5	0.78	0.79	1.46	–	0.71	+ 2.1
Greece	− 35.0	Feb	− 19.6	Feb	na	na	104.3§	105.1	0.78	0.79	1.46	–	0.71	− 4.5
Iceland	− 1.7	Mar	− 2.6	Q4	na	na	105.7**	99.4	70.4	65.3	131	90.1	63.7	+ 2.0
Ireland	+ 38.9	Feb	− 3.9	Q4	na	na	112.2§	114.8	0.78	0.79	1.46	–	0.71	− 0.9
Luxembourg	− 4.8	Feb	+ 3.6	Q4	na	na	106.7§	108.0	0.78	0.79	1.46	–	0.71	− 2.3
New Zealand	− 4.8	Mar	− 9.6	Q4	na	na	119.3	136.5	1.61	1.41	3.00	2.06	1.46	+ 5.3
Norway	+ 52.2	Apr	+ 49.5	Q4	na	na	112.5	108.2	6.11	6.41	11.4	7.82	5.52	+ 15.3
Portugal	− 23.1	Feb	− 17.1	Feb	na	na	105.3**	106.6	0.78	0.79	1.46	–	0.71	− 6.0

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, March average. ‡OECD estimate. **IMF, January average.

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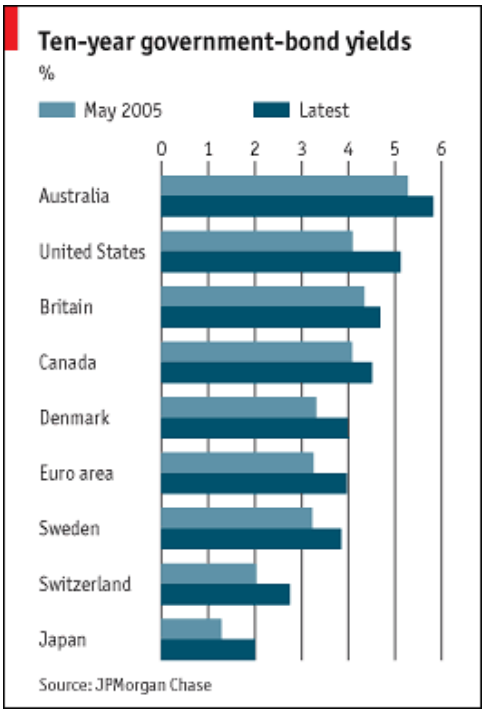
About sponsorship

Ten-year government-bond yields

May 18th 2006
From The Economist print edition



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Overview

May 18th 2006
From The Economist print edition

China's industrial production in April was 16.6% higher than it was 12 months before. Its retail sales were 13.6% greater. Consumer-price inflation picked up, from 0.8% in the year to March to 1.2% in the year to April.

India's industrial production grew by 7.7% in the year to March; Russia's by 4.8% in the year to April.

Indonesia's economy grew by 4.6% in the year to the first quarter, its slowest pace since the second quarter of 2004.

Peru's GDP, in contrast, expanded by a mighty 10.7% in the year to March, its quickest rate of expansion since 1997.

Hungary's economy grew by 4.5% in the year to the first quarter, **Israel's** by 5.2%.

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The Economist poll of forecasters

May 18th 2006
From The Economist print edition

Every three months, *The Economist* polls a group of forecasters and averages their predictions for economic growth and current-account balances in 25 emerging economies. Compared with February, the panel has become more optimistic about this year's growth, raising projections in 18 countries and lowering them for only three: Thailand, Egypt and Israel.

The Economist poll of forecasters

May

	Real GDP % change		Current account % of GDP	
	2006	2007	2006	2007
China	9.4	8.8	5.2	4.3
Hong Kong	5.6	4.8	11.5	11.4
India	7.6	7.4	−2.7	−2.6
Indonesia	5.1	5.6	1.2	0.9
Malaysia	5.3	5.2	12.8	11.4
Philippines	5.0	4.9	2.4	2.4
Singapore	6.2	5.2	23.2	20.0
South Korea	5.2	4.5	1.1	0.7
Taiwan	4.2	4.1	4.7	4.5
Thailand	4.7	4.6	−1.0	−1.2
Argentina	6.3	4.4	1.4	1.0
Brazil	3.6	3.7	0.6	0.1
Chile	5.6	5.3	nil	−0.8
Colombia	4.2	3.9	−1.5	−1.9
Mexico	3.8	3.2	−1.1	−1.5
Peru	4.7	4.2	0.5	−0.1
Venezuela	6.1	4.2	12.9	9.8
Egypt	4.9	5.0	2.1	1.4
Israel	4.1	4.1	0.7	0.6
South Africa	4.5	4.6	−4.4	−4.5
Czech Republic	5.0	4.5	−2.0	−1.7
Hungary	4.2	3.8	−8.1	−7.2
Poland	4.6	4.5	−1.5	−2.1
Russia	6.5	6.2	9.9	6.2
Turkey	5.1	5.2	−6.6	−6.2

Sources: ABN AMRO; Deutsche Bank; Economist Intelligence Unit; Goldman Sachs; HSBC; ING Financial Markets; JPMorgan Chase; Merrill Lynch; UBS.

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Economy

May 18th 2006
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+10.2	Q1	+16.6	Apr	+ 1.2	Apr	+114.1	Apr	+160.8	2005	875.1	Mar
Hong Kong	+ 7.6	Q4	+ 5.9	Q4	+ 1.8	Mar	−11.9	Mar	+19.7	Q4	127.0	Apr
India	+ 7.6	Q4	+ 7.7	Mar	+ 5.0	Feb	−39.4	Mar	−13.3	Q4	153.6	Apr
Indonesia	+ 4.6	Q1	−17.5	Feb	+15.4	Apr	+30.5	Mar	+ 3.0	Q4	38.3	Mar
Malaysia	+ 5.2	Q4	+ 3.6	Mar	+ 4.6	Apr	+26.7	Mar	+19.9	Q4	73.1	Mar
Pakistan	+ 8.4	2005†	+19.3	Sep	+ 6.9	Mar	−10.5	Mar	− 3.7	Q4	10.9	Mar
Philippines	+ 6.1	Q4	−11.8	Feb	+ 7.1	Apr	− 3.8	Feb	+ 2.4	Dec	17.9	Apr
Singapore	+10.6	Q1	+25.2	Mar	+ 1.2	Mar	+33.2	Apr	+33.2	Q4	127.9	Apr
South Korea	+ 6.2	Q1	+10.0	Mar	+ 2.0	Apr	+18.8	Apr	+ 9.6	Mar	222.8	Apr
Taiwan	+ 6.4	Q4	+ 7.2	Mar	+ 1.2	Apr	+10.4	Apr	+16.4	Q4	259.0	Apr
Thailand	+ 4.7	Q4	+ 8.2	Mar	+ 6.0	Apr	− 5.9	Mar	− 0.7	Mar	53.7	Mar
Argentina	+ 9.1	Q4	+ 3.7	Mar	+11.6	Apr	+11.2	Mar	+ 5.4	Q4	20.5	Mar
Brazil	+ 1.4	Q4	+ 5.2	Mar	+ 4.6	Apr	+45.0	Apr	+13.3	Mar	59.2	Mar
Chile	+ 5.8	Q4	+ 7.6	Mar	+ 3.7	Apr	+12.1	Apr	+ 0.7	Q4	17.5	Apr
Colombia	+ 5.4	Q1	+ 5.6	Feb	+ 4.1	Apr	+ 1.4	Jan	− 1.9	Q4	14.9	Apr
Mexico	+ 5.5	Q1	+ 9.7	Mar	+ 3.2	Apr	− 4.9	Mar	− 5.7	Q4	76.0	Mar
Peru	+10.7	Mar	+ 3.6	Feb	+ 2.9	Apr	+ 5.2	Mar	+ 1.0	Q4	13.4	Mar
Venezuela	+ 9.4	Q1	+13.6	Jan	+11.4	Apr	+31.5	Q4	+28.1	Q1	22.5	Feb
Egypt	+ 4.9	2005§	+ 4.0	2005†	+ 3.7	Mar	−11.1	Q4	+ 2.2	Q4	22.0	Apr
Israel	+ 5.2	Q1	+ 8.9	Feb	+ 3.8	Apr	− 8.7	Apr	+ 2.4	Q4	28.0	Apr
Saudi Arabia	+ 6.2	2005‡	na		+ 1.6	Feb	+84.6	2004	+90.7	2005	28.1	Mar
South Africa	+ 4.5	Q4	+ 5.7	Mar	+ 3.4	Mar	− 5.0	Mar	−10.1	Q4	21.3	Apr
Czech Republic	+ 6.9	Q4	+17.9	Mar	+ 2.8	Apr	+ 1.7	Mar	− 2.6	Q4	30.2	Apr
Hungary	+ 4.5	Q1	+11.3	Mar	+ 2.3	Apr	− 3.4	Mar	− 8.0	Q4	21.5	Mar
Poland	+ 4.2	Q4	+16.4	Mar	+ 0.7	Apr	− 2.6	Mar	− 4.2	Mar	42.3	Mar
Russia	+ 7.0	Q4	+ 4.8	Apr	+10.0	Apr	+129.9	Mar	+84.3	Q1	225.7	Apr
Turkey	+ 9.5	Q4	+ 8.9	Mar	+ 8.8	Apr	−45.8	Mar	−25.5	Mar	55.9	Mar
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+11.1	Q4	+ 6.8	Mar	+ 4.3	Apr	− 2.6	Feb	− 1.6	Mar	1.9	Mar
Latvia	+10.5	Q4	+ 9.9	Mar	+ 6.1	Apr	− 3.2	Feb	− 2.1	Feb	2.5	Mar
Lithuania	+ 8.1	Q1	na		+ 3.5	Apr	− 4.0	Mar	− 2.0	Mar	3.9	Mar
Slovakia	+ 6.3	Q1	+15.3	Mar	+ 4.5	Apr	− 2.8	Mar	− 4.2	Jan	15.9	Feb
Slovenia	+ 5.1	Q4	+ 9.9	Mar	+ 2.7	Apr	− 1.7	Mar	− 0.3	Feb	8.3	Feb

*Excluding gold, except Singapore and China; IMF definition. †Year ending June. ‡Economist Intelligence Unit estimate.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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Financial markets

May 18th 2006
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 17th		Dec 30th 2005	
	May 17th	year ago	May 17th	% a year		one week	in local currency	in $ terms
China	8.00	8.28	15.1	3.10	1,706.2	+5.2	+ 39.7	+ 40.9
Hong Kong	7.75	7.80	14.6	4.51	16,615.6	– 2.7	+ 11.7	+ 11.7
India	45.2	43.5	85.2	5.64	12,217.8	– 3.1	+ 30.0	+ 29.5
Indonesia	9,065	9,450	17,094	13.16	1,462.2	– 5.0	+ 25.8	+ 36.5
Malaysia	3.58	3.80	6.74	3.84	958.4	– 0.9	+ 6.5	+ 12.6
Pakistan	60.0	59.5	113	9.44	11,094.7	– 4.1	+ 16.1	+ 15.7
Philippines	52.1	54.6	98.2	8.13	2,463.6	– 2.6	+ 17.5	+ 19.8
Singapore	1.57	1.65	2.96	3.44	2,548.7	– 3.6	+ 8.6	+ 14.9
South Korea	937	1,005	1,767	4.37	1,401.5	– 3.4	+ 1.6	+ 9.6
Taiwan	31.6	31.3	59.5	1.70	7,116.8	– 2.8	+ 8.7	+ 13.1
Thailand	38.1	39.9	71.8	5.25	762.4	– 2.8	+ 6.8	+ 15.0
Argentina	3.04	2.89	5.74	9.81	1,683.8	–11.2	+ 9.1	+ 8.5
Brazil	2.17	2.47	4.10	15.75	38,290.0	– 8.3	+ 14.5	+ 22.9
Chile	521	581	983	4.92	10,175.7	– 0.7	+ 10.5	+ 8.6
Colombia	2,432	2,341	4,587	5.99	9,098.3	–15.4	– 4.4	– 10.1
Mexico	11.1	11.0	21.0	7.01	20,261.9	– 7.0	+ 13.8	+ 8.8
Peru	3.26	3.25	6.15	4.51	7,335.4	– 3.6	+ 52.7	+ 60.6
Venezuela	2,539§	2,602§	4,788	10.55	30,842.3	– 0.9	+ 51.2	+ 54.0
Egypt	5.76	5.80	10.87	8.66	52,217.7	– 2.9	– 5.7	– 6.1
Israel	4.44	4.37	8.38	5.54	911.6	– 0.6	+ 10.1	+ 14.1
Saudi Arabia	3.75	3.75	7.07	4.85	10,692.1	+9.7	– 36.0	– 36.0
South Africa	6.37	6.42	12.0	7.15	20,652.6	– 6.2	+ 14.1	+ 13.7
Czech Republic	22.1	23.9	41.7	2.11	1,463.1	– 4.7	– 0.7	+ 10.7
Hungary	206	199	389	6.18	22,888.0	– 9.0	+ 10.1	+ 14.2
Poland	3.07	3.31	5.78	4.15	43,072.1	– 3.9	+ 21.0	+ 28.5
Russia	27.0	28.0	50.8	12.00	1,543.3‡	–11.3	+ 28.6	+ 37.1
Turkey	1.48	1.37	2.80	14.11	40,439.2	– 7.2	+ 1.7	– 7.4
EM (MSCI)*	1.00	1.00	1.89	na	816.2	– 7.2	+ 15.5	+ 15.5
EMBI+†	1.00	1.00	1.89	na	366.9	– 2.0	– 0.5	– 0.5

*Emerging Mkts. †JPMorgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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